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IN THE

Supreme Court of the United States

October Term, 1964
No. 63

Commissioner of Internal Revenue,
Petitioner,

vs.

Clay B. Brown and Dorothy E. Brown, Donald L. Brown and Ingrid R. Brown, Charles William Booth and Nancy H. Booth, Donald Lee Brown, Phillip F. Brown, Marilyn Brown,
Respondents.

BRIEF AMICI CURIAE.

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Respondents.

BRIEF AMICI CURIAE.

Question Presented.

Whether an irrevocable transfer of corporate stock, negotiated at arm's length, in consideration of liquidation of the corporation and the transferee's agreement, secured by the corporate assets, to pay a fixed price within a reasonable range, in cash installments over 10 years, constitutes a "sale or exchange" of the stock within the meaning of Section 1222(3) of the Internal Revenue Code of 1954 (and Section 117(a)(4) of the 1939 Code) if the transferee assumes personal liability only for minimum annual payments equal to 90% of its earnings from the business before taxes and depreciation, and substantially exceeding the amount which the corporation could have earned but for the transfer and liquidation.

Statement of Interest of Amici Curiae.

This brief is filed by the undersigned attorneys as friends of the Court, with the consent of the petitioner and respondents. The undersigned attorneys variously represent the taxpayers in the cases of *Anderson Dairy, Inc.*, 39 T. C. 1027; *Royal Farms Dairy Co.*, 40 T.C. 172; *Isis Windows, Inc.*, 1963 P-H T.C. Mem. Dec. ¶63,176, and *Warren Brekke*, 40 T. C. 789, all of which cases are now pending on appeal in the Ninth Circuit Court of Appeals and are being held to await the decision in this case, and University Hill Foundation, a charitable organization affiliated with Loyola University, which was, as petitioner has pointed out (Br. p. 23), a participant in the transactions out of which all the above cases arose.[1] The Commissioner has revoked the tax exemption of University Hill Foundation and proposes to assess deficiencies against it arising from these and other similar transactions. The undersigned attorneys are also concerned, in their capacity as members of the Bar generally, with the serious implications of the theories proposed by the petitioner in this case, as these theories would (if accepted by this Court) adversely affect numerous other taxpayers, in particular those engaged in real estate transactions in California. These parties are joining together in the filing of this single brief amici curiae in order to comment upon the issues involved as they directly affect all the amici curiae, without burdening this Court with a proliferation of briefs.

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[1] The taxpayers in the cases of *Anderson Dairy, Inc.* and *Royal Farms Dairy Co.* are represented by Musick, Peeler & Garrett and Joseph D. Peeler. The taxpayers in *Isis Windows, Inc.* are represented by Willis, MacCracken, Butler & Scheifly and John E. Scheifly. Warren Brekke and University Hill Foundation are represented by Latham & Watkins, Dana Latham and John H. Hall.

Statement of Summary of Argument.

Petitioner has begged the question in this case by analogizing it to an economically meaningless, purely tax-motivated transaction in which a stockholder "sells" his stock to a "buyer" for a grossly-inflated "price" to be paid solely from corporate dividends. This analogy fails for two reasons to reflect the actual issue in the case.

I.

First, petitioner's analogy leaves out of account the fact that the Institute, which purchased respondents' stock and notes, guaranteed to make annual payments on the set purchase price which would be (and were) very substantially in excess of the annual earnings respondents could have enjoyed but for the sale. The buyer felt in a position to give this guarantee because of its tax exemption, but the guarantee was not dependent upon the continued retention of the exemption. It was therefore of no concern to the sellers whether the charity would be exempt and able to finance the purchase out of its earnings, or whether (as petitioner ~~had~~ has determined) it was not exempt, and hence will be required to dig deeply into its own pocket to make the required payments and still pay its state and federal taxes. This guaranteed payment of amounts equal to 90% of the Institute's receipts *before* taxes and depreciation provided a substantial economic *quid pro quo* to the sellers by providing acceleration of receipt and a cushion against reduced profits. It made it possible for the buyer to negotiate a sales price which the trier of fact has held was set by arm's-length negotiations on the basis of actual values, and was within a reasonable range in terms of these values. This realistic price alone furnished sufficient proof that the transaction in fact was not of the category of economically meaningless transactions at substantially excessive prices which petitioner contends "must have" occurred, and negates his contention that the sale was merely a device for transmuting ordinary income into capital gain. The sellers' capital gain treatment (contrary to petitioner's theoretically-based arguments) was a tax benefit they would have been entitled to on *any* installment sale, so that ordinary income treatment of the sales proceeds would be highly unfair to the sellers and a windfall to petitioner. The facts of the case show that the purchase price for the stock (about seven times average after-tax earnings without allowing for the very substantial net worth of the assets) was not unreasonable. The facts in numerous similar cases, in which the prices were also found to be well within a reasonable range, further belie petitioner's theoretically-based conclusions.

Petitioner's approach is at root an attack on the findings of the trier of fact, but instead of attempting the impossible task of proving them clearly erroneous on the evidence, he seeks to brush them aside because they are irreconcilable with his theory. It is, however, the theory that is clearly erroneous, because it is based on an inapplicable analogy, and not the facts.

II.

The second fallacy with petitioner's analogy is that it leaves out of account the fact that the transfer of respondents' stock and notes to the Institute in exchange for the Institute's $1,300,000 note was a realizing transaction, and therefore a sale or exchange, rather than petitioner's theoretical model of the mere retention of an income interest with the transfer of a remainder. This Court has repeatedly held, and the statute clearly provides, that the conversion of one property interest into another substantially different interest constitutes a realizing sale or exchange, on which, in the absence of any applicable non-recognition provision, gain or loss must be reckoned. Because such recognized gains constitute the sum of previously unrealized annual increments of value in the capital asset so disposed of, these gains fit precisely within the category of gains for which long-term capital gain treatment was primarily designed. The sale here was such a conversion, for the sellers irrevocably disposed of their stock, the corporation was liquidated, and sellers received in exchange only a note of the buyer secured by the corporate assets, which was eventually paid (to the extent of $936,131.85) in cash installments.

Once petitioner's argument is stripped of the overtones of pure tax motivation and economic unreality which are the products solely of his theoretically-oriented reliance upon an inapplicable analogy rather than the actual facts of the case, his only remaining contention is that a "sale" within the common understanding of the term is *not* a sale for purposes of Code Section 1222 if full payment of the purchase price is inadequately secured, or is otherwise dependent upon the subsequent productivity of the asset transferred. This contention, however, flies in the face of the well-settled doctrine of realization, one of the very cornerstones of the tax law, which has always required simply a genuine conversion of one asset into another significantly different one (*e.g.* the exchange of shares in a New Jersey corporation for shares in a Delaware corporation representing the same business), and never the termination of the business risks associated with the first asset. On numerous occasions, this Court and lower Courts, the Congress and the Commissioner himself have acknowledged as sales and other exchanges transactions involving precisely these elements of continuation of risk and dependency upon earnings. In fact, as late as this year, although the Treasury had in 1963 requested Congress to enact legislation taxing earnings-dependent sales proceeds as ordinary income, Congress refused and instead, in Internal Revenue Code §483(d) adopted the more limited approach of taxing as ordinary income only an imputed interest element upon this type of sales. The Treasury, which, when addressing Congress, conceded that capital gain treatment can apply to such sales under present law, now in effect asks this Court for the legislation Congress denied.

In seeking to exclude high-risk or productivity-dependent transactions from the category of sales, the Commissioner is not only flaunting the expressed will of Congress, but is also defying the well-settled principle that whenever possible terms in the tax law such as "sale or exchange" should be given their ordinary meaning. Ample authority demonstrates that high-risk or productivity-dependent cash transactions are not in common understanding excluded from the category of "sales."

Because the actual case, unlike petitioner's hypothetical, is no different, from the sellers' viewpoint, from a host of other clearly realizing transactions in other areas, adoption here of the revolutionary principles advocated by petitioner would cast widespread confusion and doubt upon large numbers of bona fide commercial transactions. For example, it would remove from the category of "sales" uncounted thousands of real estate transactions in the Southern California area alone. The Code neither contemplates nor provides for a category of bona fide complete dispositions of capital assets for cash which are not sales. The creation at petitioner's behest of any such category would be to plunge into an uncharted and thorny thicket of unanswered questions, to create unnecessary and burdensome new areas of artificial definitions in the already complex tax law, and to impose an arbitrary judicial solution upon what is basically a complex legislative problem.

The only authority cited by the petitioner for his bold and sweeping request is a line of cases in the oil and gas field. It is doubtful whether such authorities, arising in an area of the tax law which is shaped by the depletion allowance and other unique factors, should be applied in other areas. Be that as it may, if the oil and gas principles *are* applied to this situation, the result is no different, since this Court's decisions in that field make it clear that both (a) the sale of an oil corporation's stock followed by a corporate liquidation and payment through an oil royalty interest, and (b) a sale of oil and gas property in which the oil royalty is supplemented by a lien on the fee title to transferred lands are *sales* and not reserved income interests. These decisions in oil and gas cases on facts analogous to those of the present case leave no room for petitioner's reliance on this line of cases.

Petitioner calls this "a tax case of rare importance" (Pet. p. 7). Its importance lies, however, not in the opinion below, which merely reflects the unanimous consensus of this Court and all lower Courts that the concept of "sales" is not as sharply limited as petitioner appears to desire, but in the hitherto unheard-of limitations petitioner first sought unsuccessfully from Congress, and now seeks from this Court. Because the case does not on the actual facts involve the economically unreal, tax-motivated type of transaction which petitioner stated that it did in requesting certiorari, because there is no conflict in the lower Courts and the applicable principles of law are there clearly understood, and because the Court of Appeals reached a correct result which gave respondents no tax benefits to which they would not be entitled on any installment sale, this Court should now resist petitioner's demand for gratuitous and far-reaching judicial legislation, and should dismiss this case because of the improvident granting of the writ of certiorari. Failing this, the opinion of the Court below should be affirmed.

ARGUMENT.

INTRODUCTORY.

Petitioner's brief is almost completely devoted to discussion of a set of facts not in issue. It first sets up as a "straw man" a hypothetical stockholder who purports to "sell" his stock for a right to receive all dividends up to a stated amount (Br. p. 16).[2] Throughout the rest of the brief petitioner mercilessly belabors this straw man, but nowhere can or does he demonstrate the straw man represents the actual case. One of petitioner's learned counsel once aptly quoted:

> "Beware the metaphor! Of all the anodynes for the pains of thought, it is the most seductive, the most misleading." Brown *The Growing "Common Law" of Taxation,* 34 So. Cal. L. Rev. 235, 244 (1961).

The same could with equal propriety be said for the extended analogy on which petitioner so completely relies.

The factual differences between petitioner's straw man and the facts of the actual case are not matters of detail and are not mere speculations or inferences. They are clearly set forth in the record of the case and, as we will show, are crucial and determinative of the correct result. To put these differences in a nutshell, the straw man's actions make no economic sense, would only occur for tax purposes and would necessarily involve a grossly excessive "purchase price" (any negotiations over which would be pure sham). Because the

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[2] References herein to Petitioner's Opening Brief will be cited "Br. p. 16"; references to the Record will be cited "R. p. 64"; and references to the Petition for Certiorari will be cited "Pet. p. 10."

"purchase price" would grossly exceed fair value for the stock, the predominant nature of the straw man's "sale" would be simply the retention of the "seller's" dividends on his stock for an extended term. A remainder interest would be gratuitously transferred to the "buyer" in the perhaps illusory hopes of obtaining more favored tax treatment on the retained dividends. Moreover, no corporate liquidation would be part of the transaction, so there would be doubt whether the transaction would involve realization of any gain on the stock itself, or (as petitioner contends) would be the mere retention of an income interest. Were such a maneuver successful in producing capital gain, it might indeed involve the "extraordinary tax benefits" which petitioner claims (Br. p. 26) to find in the present case. However, this is *not* the case before the Court, and it is not necessary for the Court to decide what the tax consequences of such a transaction would be.

The record of the actual case, on the other hand, shows conclusively that the transaction made good economic sense to the sellers without reference to their income taxes and without an unreasonably high price, and that the parties, at arm's length, negotiated a purchase price based on actual value and within a reasonable range in the light of the corporation's assets and earnings history [R. pp. 32, 57, 64]. Furthermore, the liquidation of the corporation—an exchange which would *alone* trigger realization and recognition of capital gain on respondents' stock—was part and parcel of the actual transaction. Accordingly, as we will show, the gain on the actual transaction was simply a realization in cash installments of the hitherto unrealized increments in value of the stock sold—precisely the type of transaction for which long-term capital gain treatment is primarily intended. No "extraordinary tax benefits" are involved, for (at least as long as the price *is* within a reasonable range) the taxpayer is getting nothing he would not be entitled to in any other installment sale. In fact to tax such gain at ordinary rates would be an outright windfall to the government.

In this brief we will first explain why the petitioner's straw man does not represent the actual case and why the differences between them are determinative. Secondly, having disposed of the smokescreen thrown up by the petitioner's assumed "simplified version" of the facts (Br. p. 30), we will explain why the lower courts were clearly correct in holding that the actual transaction constituted a "sale or exchange" for purposes of Section 1222(3) of the Internal Revenue Code of 1954.

I.

PETITIONER'S UNSUPPORTED ASSUMPTION THAT THIS CASE PRESENTS THE SAME ISSUES AS A MERE TRANSFER OF STOCK FOR A PURCHASE PRICE PAYABLE ONLY FROM SUBSEQUENT DIVIDENDS, AND SECURED ONLY BY THE STOCK TRANSFERRED, BEGS THE QUESTION IN THE CASE.

A. The Essential Differences Between Petitioner's Assumed Case and the Actual Facts Are the Actual Transferee's Ability to Double the Earnings of the Business Assets in Its Own Hands, Its Commitment to Pay the Full Purchase Price in a Substantially Shorter Period Than the Corporation Would Have Been Able to Earn a Similar Amount, and the Corporate Liquidation as an Essential Part of the Transaction.

Petitioner's "straw man" may be illustrated by assuming that S owns 100% of the stock of X corporation, which has annual after-tax earnings of $100,000 and a fair market value of $1,000,000 (ten times earnings). If a would-be buyer offers to buy the stock for a "purchase price" payable solely out of the dividends, in annual installments for a given period, the offer would make no economic sense and would not be considered except for tax reasons. It would not reduce S's risks on the downside. He would receive the "purchase price" no faster than an equivalent amount would come in the form of dividends without the "sale," and tax savings aside, he could only end up a poorer man, at any price. Even if the hoped-for tax savings were guaranteed, the "purchase price" would have to be so grossly excessive that the tax savings on the payments made *after* payment of full value would compensate for the purely gratuitous sacrifice of the remainder interest.[3] Because of its lack of economic justification such a transaction might fall within the ambit of *Knetsch v. Commissioner,* 364 U. S. 361 (1960). The Court does not have to decide this, however, since such facts are not before it.

Suppose, however, that B, a solvent and reputable would-be purchaser, makes a proposition which with minor variations is essentially similar to the transaction in the actual case:

> "I will buy your stock for $1,000,000 and liquidate your corporation. With the assets in *my* hands, I plan to double the annual earnings of the business — whatever they otherwise would have been in the corporation's hands. Accordingly, I will pay the $1,000,000 in annual installments equal to the greater of (a) $100,000 or (b) double the amount X corporation would have earned had it retained the business and assets, full payment to be made within not less than ten years. I will pay double these earnings whether or not I am correct in believing that earnings will be doubled in my hands. Beyond this I will assume no personal responsibility, but the assets of the business will constitute security for payment of both the minimum annual installments and the full $1,000,000."

From the seller's viewpoint, this is a very different proposition. S is offered a substantial and meaningful *economic quid pro quo* for the seller's cutoff of all rights on the "upside." By virtue of the guarantee of doubled earnings, he receives a reasonable "cushion" of assurance that full payment of the purchase price will be made within the stated period, and has the absolute assurance on the downside that even if economic disaster strikes the business and the buyer fails to complete payment within the prescribed period, the seller will at least be substantially better off than if no such transaction had been entered into. These facts are true *without regard* to the income taxes that the seller will be required to pay.[4]

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[3] Even then, as petitioner concedes, the transaction would be unrealistic with a taxable buyer because the adverse tax consequences to the buyer would prevent such an arrangement. See *Vermont Transit Co. v. Commissioner,* 218 F. 2d 468 (2d Cir.), *cert. denied,* 349 U. S. 945 (1955).

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[4] The difference between the tax rates applicable to ordinary income and to long-term capital gains will (*ceteris paribus*) cause a holder of appreciated stock of a closely-held corporation to prefer the realization of his gain through a final disposition such as sale of his stock or liquidation of the corporation, to the distribution of dividends taxable at ordinary rates. Although in economic fact the realized gains on a final disposition primarily represent the sum of past undistributed corporate earnings and the discounted expectancy of future profits, the tax law creates a strong bias in favor of realizing on such past earnings and future expectancy through a sale or liquidation rather than through retention of the stock and receipt of dividends. Any experienced tax practitioner can testify that sales of stock and liquidations are common, but the declaration of a dividend by a closely-held corporation (other than a "tax option" corporation) is a rarity. This bias toward the sale or exchange was preferred by Congress to the locked-in effect which would have been caused by taxing gains on such transactions at ordinary income rates. See *Commissioner v. P. G. Lake, Inc.*, 356 U. S. 260, 265 (1958). Thus many if not most sales of stock, including presumably the ones before the Court, are "tax-motivated" in that they would not have occurred had the gains been taxable at ordinary rates. This does not, however, solve the question before the Court—which boils down to whether the price was set within a reasonable range by arm's length negotiations (as found by the Tax Court) so that the gains in question predominantly constituted the realization of past accrued values, or whether (as claimed by petitioner in the teeth of these findings) the price was not set by good-faith bargaining and substantially exceeded fair value, so that to the extent of such excess there was arguably the retention of an interest in future earnings.

The economic consequences of our hypothetical transaction are quite different from the "straw man." If the business continues at the same level, B will pay $200,000 per year. S will have his $1,000,000 in five years and walk away without subsequent worries about the fortunes of the business. He will have received this sum five years earlier than he could have received such a sum from earnings, had he not sold his stock. If profits *improve,* S will get *no more* than his $1,000,000, but payment will be completed faster. Even if both profits and the value of the business assets decline substantially, S is still reasonably secure, since the doubled earnings provide a good cushion. If there is an immediate drop of, *e.g.,* 50%, in profits, S will *still* receive his full $1,000,000, even without recourse to his security. In such event, it will take the full 10 years provided in the agreement—but if S had not entered into the transaction, he would only have received $500,000 of earnings during the same period, so he is well ahead economically. Even if both profits and asset value decline immediately by as much as 60%, so that the business would have earned only $40,000 annually in S's hands, and B's actual annual personal liability will only be $80,000, B must either pay $20,000 more per year (or $200,000 over the 10 years) or face foreclosure by failing to meet the required $100,000 minimum annual payments. If the business is still worth $400,000, a rational buyer will come up with the $200,000 to save it. Each year in which payments are received increases S's cushion and puts him in an even more secure position.

Since S can predict results for the immediate future with more assurance than later events, a substantial measure of added security is provided by the early payments. S's substantial and growing cushion leaves the assets as security for only a fraction of the purchase price—exactly the situation in which the petitioner has said there would be a sale (Br. p. 19).

A complete economic disaster occurring to the business, particularly in the early years of the payout, may prevent S's receipt of the full purchase price, just as it could with a down payment. However, even in such unusually adverse circumstances, S will at least be substantially better off economically (without reference to his taxes) than he would be if he had not sold the stock. For instance, if after 3 years profits unexpectedly stop *completely* and the value of the assets declines 70% (from $1,000,000 to $300,000) S will at least have received a total of $900,000 of his agreed purchase price—$600,000 in annual installments and $300,000 on foreclosure and sale of the assets. Taxes aside, he will be $300,000 richer than he would be had he not sold and had the same disaster occurred. The sale will have the effect of shielding him from most of the downside loss he would have incurred by retaining the stock.

To put this in other words, even if petitioner's theoretical analysis demands a cushion of added *assets* (*e.g.,* a large down payment or substantial personal liability), in the market place a cushion of added *earning power* provides equally satisfactory assurances of final payment. The market place measures an income-producing asset principally in the light of the income it produces, and if it can be made to produce double the income, it is worth twice as much in terms of security. The buyer who will guarantee this has quite as much to bargain with as the buyer who puts up a down payment. The proof of this proposition is the actual facts of this case, in which the price was within a reasonable range in the light of earnings and net worth [R. p. 64]. No doubt a down payment *added* to this cushion even further reduces the elements of futurity and risk. However, the effect of a down payment on the sellers' thinking was scarcely as earth shaking as petitioner believes, since the sellers themselves initially offered a price reduction of only 11.2% for a cash down payment.[5] From the practical standpoint with which risk is weighed in the market place, B's accelerated payment proposal may indeed be preferable to a mere down payment with slower installments, since the "cushion" afforded by B's transaction continually swells and reaches its maximum during the latter part of the payout period when the crystal ball will be cloudier and risk of disaster greater, while the cushion of a down payment remains constant. However, we are here comparing only relative degrees of risk in different economically viable transactions—an entirely different matter from the economically nonsensical proposition of petitioner's straw man, in which all possibility of gain on the upside would be sacrificed with no concomitant acceleration or downside cushion whatsoever.

Petitioner relies upon the proposition that where a buyer contributes nothing, normal bargaining over value will not exist, and an unreasonably high price will necessarily emerge. He concedes that a buyer's pledge to contribute added income through his *services* may permit characterization of a transaction as a sale (Br. p. 62). In his brief, he nowhere explains why a transferee's guaranteed contribution of added income arising from the transferee's expectation of tax exemption (but nonetheless guaranteed) does not have the same economic result.[5a]

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[5] Sellers' initial offer was $1,440,000 without a down payment or $1,280,000 with a down payment [R. p. 27].

The key factor which distinguishes the case which petitioner is arguing from the actual case is that the Institute's expectancy of a substantial increase in the earnings of the assets taken through liquidation directly into its hands permitted it to contract to pay full fair value for the stock from the thus enhanced earnings in a far shorter period of time than the same amount would have come to respondents in the form of dividends from corporate earnings, or even in the form of, *e.g.*, a 30% down payment followed by delivery of all subsequent dividends received until payment in full. Here we have an *exchange* of asset values for cash, and for cash in substantially greater amounts than would have come through earnings during the payout period; not the straw man's gratuitous *sacrifice* of asset values without receipt of such extra cash. The difference is vital, because where there *is* a substantial *quid pro quo* and reasonable assurance of payment there will be a bargaining situation resulting in a price within a reasonable range of fair value; in the straw man case where a "buyer" supplies no *quid pro quo*, he has nothing to bargain about, the rules of the market place will be inapplicable, and any resulting purported sale would merely be a gratuitous transfer of a remainder interest in stock in hopes of reducing the taxes on subsequent retained earnings. In *assuming* that there will be no liquidation and that payment will simply be out of dividends (Br. p. 29), petitioner assumes away the very economic *raison d'être* of the actual transaction and completely begs the question.[6]

[5a] In his Petition (p. 24 n. 30), he appears to admit this, although he argues that the resultant bargaining had a different content from commercial bargaining—a contention belied by the Tax Court's findings [R. p. 32].

A seller will in practice, of course, demand something more for any installment sale than presently-realizable *cash* value, in order to compensate him for the elements of futurity of payment and residual risk of non-payment. We do not understand petitioner to argue (nor could he rationally) that an installment sale is not a sale for tax purposes until *all* futurity and risk of payment are removed. The only sale so qualifying is a 100% cash purchase. The very existence of Internal Revenue Code Section 453 demonstrates clearly enough that the term "sale" is not so narrowly restricted. Petitioner, however, does contend:

> And a necessary consequence of *the price being greater than the presently-realizable cash value* of the stock is that A will not only bear the full risk of any future losses but will also share in the benefit of any future income production or capital appreciation. What he receives, therefore, will represent not the proceeds from his "cashing in" on the values accrued in the past (*i.e.*, the present value

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[6] Moreover, in simply *assuming* (contrary to fact) that the liquidation was not a relevant part of the entire transaction, and "can be ignored" (Br. p. 27), petitioner attempts to sidestep a further crucial difficulty with his argument—the clear existence in the actual case of a *realizing transaction* on which gain must be recognized, rather than the simple *reservation* by a stockholder of an interest in corporate dividends. See pp. 42-60 below.

> of the stock), but the proceeds of his continued risk-bearing participation in the future gains and losses. (Br. p. 37.) (Emphasis added.)

Taken literally, this contention *would* damn all installment sales, for in every such sale a seller will charge *something* more than "presently-realizable cash value," for futurity and risk, whether such excess takes the form of "interest" or merely a higher "time-price." See *M. Pauline Casey,* 38 T. C. 357, 382-83 (1962).[7] We cannot believe, however, that petitioner intended to go so far. He expressly concedes, as he must, that "normal" installment sales are sales, no doubt despite this inevitable increment in price. Nor does petitioner merely contend that long-term capital gain treatment is available to so much of the price as represents "cash" value, while only the increment which represents futurity and risk receives ordinary treatment,[8] since he argues that where the price exceeds a cash price there is no sale at all but only a reserved income interest, and would treat the entire payments as ordinary income. Petitioner's argument, taken literally, proves too much. It can apply, if at all, only to situations like his straw man case where the elements of futurity and risk are so *extreme* that the purchase price will contain an *inordi-*

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[7] When compensation for risk and futurity takes the form of a time-price differential, there may be a question whether such an increment should be treated as "interest" for tax purposes. This question is not present in the case at bench, however, because it was decided adversely to petitioner by the Tax Court [R. pp. 69-71], and because petitioner has not preserved the issue on appeal [R. p. 289]. The point is moot for future transactions because Congress this year enacted Section 483 of the Internal Revenue Code, which automatically provides an imputed interest element on deferred payment sales the terms of which do not provide for sufficient interest payments.

[8] In any event, such an argument is here foreclosed. See note 7.

nate element of compensation for futurity and risk, and will therefore *not* be within a reasonable range in the light of the asset values and earnings history of the business. Here, however, petitioner runs into the inescapable differences between his straw man case and the actual facts. Whether or not the type of "cushion" which the Institute guaranteed meets petitioner's theoretical formulation of what a cushion should be, the stubbornly inescapable central fact is that in the market place that cushion was sufficiently significant to produce a negotiated price within a reasonable range in terms of true value, and not the grossly inflated price imagined by petitioner in the case of his straw man [R. p. 64]. As a matter of hard practical fact and not of mere theoretical analysis, the futurity and risk elements of the transaction in question fit comfortably within the generality of installment sales and bear no resemblance to the extreme facts upon which petitioner relies.[9]

From the respondents' viewpoint, the substance of the actual transaction in this case was the same as in the above somewhat simplified example. As long as respondents retained their stock, over one-half of the corporate earnings would go to pay federal and state corporate income taxes. The Institute offered to buy the stock, liquidate the corporation, continue the business with ownership of the assets in the Institute's hands, and make annual payments to respondents on the purchase price at the rate of 90% of its rental receipts, or 72% of earnings *before taxes and depreciation,* which payments would be very substantially in excess of the earnings the corporation could have enjoyed had there been no sale.[10] Apparently as a precondition to the sellers' agreement to sell [R. p. 273], the Institute expressly agreed to pay these amounts in all events, and did *not* condition its agreement on the absence of taxation to it [R. pp. 200, 203]. Respondents, of course, had no reason to care, as long as the Institute guaranteed these payments, whether the Institute would, as it expected, remain tax-exempt and meet this guarantee without out-of-pocket expense, or whether it would later be taxed on the same receipts at 52% plus state taxes,[11] and therefore bear a substantial out-of-pocket

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[9] Even if (untrue in the present case) the risk of nonpayment and the element of futurity had been so great, and the compensation for these elements so substantial, that the total purchase price *exceeded* a reasonable range, this would not (at least short of petitioner's imagined economically meaningless transaction) mean that no *sale* had occurred. In the straw man case, the element of futurity becomes so great that the "sales price" will be paid only at the same rate as the income the "seller" would otherwise have earned, and the element of risk becomes infinite, because there is no cushioning whatsoever of the seller's downside risks to compensate for the sacrifice of possible appreciation on the upside. Therefore, there is no *economic* justification for less than an *infinite* amount of compensation for risk and futurity, and the transaction would occur at all only for tax purposes. Of course, this Court need not

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decide what the tax results of such an extreme transaction would be, since no such transaction is before it. Whatever may be the appropriate tax treatment for those portions of the purchase price representing risk and futurity, a portion of the payments in any genuine negotiated final disposition for cash installments will be simply the underlying cash sales value of the property, which if stated separately from the compensation for risk and futurity is clearly entitled to long-term capital gain treatment. To argue that there is no sale without such a separate statement is absurd, since mere labelling cannot make the difference between a "sale" and a "reserved income interest."

[10] Depreciation deducted for the year ended April 30, 1952 was $49,722.99 [R. pp. 161, 166]. Hence the exclusion of depreciation as well as taxes in computing earnings was a material benefit to respondents.

[11] In California, taxable corporations must pay a franchise tax, which during the years in issue was at the rate of 4% of income, and is now 5.5%. Cal. Rev. & Tax. Code § 23151.

burden. In either case, the *guarantee* of accelerated payments to the respondents provided substantial bargaining power to the Institute, as the realistic price confirms.

We believe the Institute is correct in its belief that Congress did not intend to subject it to tax on rentals received under a five-year lease. However, this will be resolved at another day and in another court.[12] Suffice it to say that the petitioner can scarcely be serious in claiming (Br. p. 58) that the Institute assumed no risk of out-of-pocket expense in making its guarantee, since petitioner officially holds that such receipts are taxable to charities, Rev. Rul. 54-420, 1954-2 C.B. 128, and since petitioner has revoked the Institute's exemption and seeks in a pending Tax Court case to tax it on the very same amounts which in this proceeding he would also tax to respondents [R. pp. 141-142]; *West Los Angeles Institute for Cancer Research v. Commissioner,* Tax Court Docket No. 94372.

It is also clear that if the Institute *were* to pay an exorbitant purchase price for the stock it would be vulnerable to loss of its exemption on the grounds of causing an inurement of earnings to private individuals. Section 501(c)(3). In the one case of this type in which an exorbitant price *was* paid, in fact, the feeder corporation was held not to be exempt for this very reason. *Emanuel N. (Manny) Kolkey,* 27 T. C. 37 (1956), *aff'd on other issues,* 254 F. 2d 51 (7th

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[12] The legislative history of the 1950 "Supplement U" amendments to the 1939 Code demonstrates complete legislative familiarity with the present problem. See H. R. Rep. No. 2319, 81st Cong. 2d Sess. 36-40 (1950). The legislative decision, in effect, permitted sales to charities financed through leases not in excess of 5 years.

Cir. 1958). Consequently, to the normal assurances of reasonableness of price provided by arm's length negotiation in a true bargaining situation can be added the further guarantee that the charity's own tax position would not permit an unreasonably high price.

Further guarantees of a price within a reasonable range are found in the practical effect of the five-year business lease provisions of Sections 512(b)(3) and 514(b)(1). All negotiations were conducted on the basis that the Institute must anticipate complete payment at least within the five-year term of the original lease [R. pp. 29, 32-33, 35, 36, 138-139, 272]. This, as a fully informed Congress presumably intended when these provisions were enacted in 1950, set a practical limit on the purchase price of about 3.6 times anticipated annual before-tax earnings[13] (about 7.2 times after-tax earnings), scarcely so exorbitant as to negate a sale. Finally, even the sellers would not have been anxious to seek a price unrealistically out of line in the light of the true earnings capacity of the business, because of the drastically unfavorable tax consequences of foreclosure. In the event an inflated price was established, if it had become necessary to take back the property, all hitherto unrecognized gain would be immediately recognized up to the fair value of the property upon repossession by the seller, and the sellers would be left "high and dry" with a large immediate tax bill and no money to pay it.[14]

Certain restrictions and obligations of the Institute as a charitable institution shaped and determined the detailed form which the transaction took, but did not change its basic nature as a sale. Direct operation of a business was neither an appropriate undertaking for a bona fide charity nor was it permitted without adverse tax consequences under Section 514. Consequently, an operating company (Fortuna) was formed with the investment of independent capital, and the business assets were rented to Fortuna. The Institute charged rent to Fortuna for the assets in an amount equal to 80% of the company's profits before taxes and before depreciation; thereby receiving its return on the investment in the permitted and appropriate form of passive rental income. Mr. Brown held no equity in Fortuna and did not share in its profits and as manager until 1954 received only a salary for his services as an employee [R. pp. 44, 48]. The Institute made no down payment for the business except out of the acquired assets since it could well be construed to be improper for a charitable organization to accumulate funds out of tax-free income for the purpose of subsequently buying businesses. Section 504(a)(1). The Institute insisted upon retaining 10 per cent of its rental receipts during the payout period, since it is prudent for a charitable institution to require some current return, even during a buyer's payout period.[15] These facts reduced the buyer's guaranteed payments to the sellers to amounts equal to 72% of the earnings before taxes and depreciation, but this amount still far exceeds the less than 48% of earnings before state and federal taxes available but for the sale. Like any buyer of income-producing assets, the Institute hoped and expected to recoup the purchase price from subsequent earnings. Due to its tax exemption, however, the Institute's earning power was so much greater than that of respondents' corporation that it could, without anticipating out-of-pocket expense, make payments which would cause a normal buyer to dig deeply into its own pocket. As long as the seller gets a fair price and reasonable payments, however, he is unconcerned over where the buyer gets the money, and there is no reason for this to affect the seller's tax consequences.

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[13] 72% x 5 = 3.6. See note 12.

[14] Section 453(d).

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[15] See the argument made by the government in *Knapp Bros. Shoe Mfg. Corp. v. United States,* 142 F. Supp. 899, 902 (Ct. Cl. 1956).

B. The Facts Not Only of This Case But of the Numerous Other Similar Cases Show That the Economically Sound Transaction, Not Involving a Grossly-Excessive Purchase Price and Not Conforming to Petitioner's Model, Is the Normal Situation.

1. The Facts of This Case Show, and the Tax Court Held, That the Purchase Price Was Negotiated at Arm's Length on the Basis of Actual Values, and Was Within a Reasonable Range in the Light of Corporate Earnings and Net Worth.

On the view petitioner takes of the case, true installment sales can be readily distinguished from the economically unreal transactions to which he would not accord capital gain treatment by the degree to which the buyer furnishes a real *quid pro quo* for the seller's relinquishment of upside possibilities, and can therefore bargain for a fair price. He further contends that a grossly-excessive purchase price is both the infallible touchstone by which the unreal, purely tax-motivated transaction can be spotted (Br. pp. 20, 37), and the principal reason for denial of capital gain treatment thereto (since, in his view, to allow such treatment of sums paid *after* receipt of a reasonable price is so to tax mere dividends, for which such favorable treatment was never intended) (Br. pp. 37, 59-60). Thus in petitioner's view, the entire case hangs on the reasonableness of the purchase price.

All this is interesting as a matter of theory. However, eventually petitioner has to get down to the *facts of this case,* and it is at this crucial juncture that the essential weakness of his theoretically-oriented argument becomes most glaringly apparent. *For the facts of the case simply do not fit petitioner's theoretical model.*

Petitioner "assumes" there was no liquidation (Br. pp. 16-17, 27-29)—but there *was.* Petitioner "presumes" the purchase price substantially exceeded fair value—and "shows" that the bargaining must have been economically meaningless (Br. pp. 20, 36)—but the trier of fact held to the contrary [R. pp. 32, 64].

Petitioner's theories are a Procrustean bed to which the awkward facts of this case bearing on the crucial and sensitive question of value do not readily conform. We regret to be forced to say that at certain points in petitioner's brief, it appears that, like Procrustes, he has stretched a fact here and chopped off one or two there, at points where such treatment would help the facts better fit his preconceptions.

We refer to the following:

(1) At page 18 of petitioner's brief appears this sentence:

> Since no reasonable man moved only by economic considerations independent of taxes would agree to such a transaction with a stranger however great the stated amount of dividends to be remitted

> might be, and since the stated amount must be substantially greater than the present value of the stock for the transaction to yield even a tax advantage, it must be presumed that the amount agreed upon in such a transaction between strangers is in fact—*as the courts below acknowledged it probably was here—substantially greater* than the value of the stock at the time of the transaction (Emphasis added).

We find nothing, and petitioner cites nothing, in the opinion of either of the "courts below" which supports the key words "substantially greater," and nothing at least in the Tax Court's opinion (the trier of fact) which justifies the word "probably." The Tax Court *did* state that the price "was the result of real negotiating," and "within a reasonable range in light of the earnings history of the corporation and the adjusted net worth of the corporate assets" [R. p. 64]. It *did* say, accepting the Government's contention for the sake of argument, that "It *may* be, as respondent contends, that petitioner would have been unable to sell the stock at as favorable a price to anyone other than a tax-exempt organization," [R. p. 62] (Emphasis added). It also said that (on the same assumption) a sale is not to be ignored for tax purposes because of a *"somewhat higher* price than someone else might pay" [R. p. 62] (Emphasis added). There is a difference, we submit, between "somewhat higher"—which would be true of any installment sale—and *"substantially higher."*

(2) Corporate net worth is an important criterion in fixing value. On this, petitioner says only:

> At the close of its fiscal year ending April 30, 1952, the Corporation's net worth was $397,782.10 [Ex. 21-U, R. 167] (Br. p. 4).

In all fairness he might not have "chopped off" the following further facts:

(a) The quoted figure represented not "net worth" but *book* net worth. There can be (and was here) a big difference.

(b) In order to compare even "book" net worth with the $1,300,000 purchase price, $125,000 must be added for stockholder notes included in that figure—making $522,782.10 as of April 30, 1952 [R. p. 37].

(c) By the date of the sale, book net worth (including the said notes) had grown to $619,457.63 [R. p. 22]. Thus book net worth *alone—i.e., actual cash shareholder investments and tax-paid corporate earned surplus*—accounted for almost half of the full sale price, without any allowance for the substantial appraised appreciation in value of corporate assets or for the expectancy of future earnings, let alone for a reasonable time-price differential.

(d) Most important of all, the Institute entered into the transaction in reliance upon the company's *appraised* net worth which (with apparently unchallenged post-appraisal adjustments) came to $1,064,877 [R. p. 32]. This figure alone (without allowing anything for the high corporate earnings expectancy) represented 82% of the agreed $1,300,000 purchase price of the stock and notes combined. The remaining 18% is well within a normal range of time-price differential [R. pp. 32-33]. This net worth figure was based on an appraisal made two or three years before the sale, and updated for subsequently acquired assets [R. pp. 135-

Institute as simply a mendicant, hat in hand, readily replaceable and ready to pay without argument the highest price the sellers felt they could get away with (Br. pp. 33-34). In fact, the Institute only selected 2 of some two dozen deals it looked at [R. pp. 36, 138].

Even the unexpected post-sale impact of adverse economic events, far from indicating an economically meaningless transaction, highlights the substantial downside protection given respondents by their sale. In the teeth of the unforeseen economic disaster which entirely choked off the previously high profits of the business and reduced the net asset values to a mere 23% of their original worth,[16] the sellers received $936,131.85, or 72% of the agreed purchase price. Had the sellers *retained* their stock instead of selling it, and had the same reverses occurred, they would have been poorer by at least $250,000,[17] without reference to their personal income taxes. They ended up, therefore, in no worse position than they would have been in with a $250,000 down payment and subsequent installments of all after-tax earnings. Had the economic decline been less extreme, full payment would still have easily been made.

In view of the petitioner's convincing proof (Br. p. 36) that a substantially excessive price necessarily marks the non-negotiated, economically unreal transaction of the type to which he would equate the sale of respondents' stock, the well-supported determinations by the trier of fact that the actual sale price was negotiated at arm's length in terms of actual values, and was within a reasonable range in those terms [R. pp. 32, 57, 64, 66-67]—if accepted by petitioner—are demonstration enough that the sale was no such transaction. Since petitioner's conception of the sale cannot possibly be reconciled with the Tax Court's factual determinations, however, we can only conclude that petitioner's brief is really an attack on these findings (*Cf.* Br. pp. 56-57). But these findings must stand unless clearly erroneous.[18] If it *is* petitioner's position that the findings are clearly erroneous, then their solid factual support in the record seems to have caused him to choose a most unusual and circuitous mode of attack. *Ignoring* the actual evidence, he has adopted a purely theoretical approach, in which he "proves" by assuming a "simplified version of the transaction" that the sale was without economic meaning. Like the learned professor who "proved" by aeronautical theory that the bumble-bee cannot fly, petitioner should look up from his theorizing long enough to face the facts.[18a]

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[16] From $1,300,000 to $300,000 [R. p. 55].

[17] Fortuna net profits from February 4, 1953 to October 31, 1957 were about $805,000 *before depreciation* [R. p. 56]. Had these profits been earned by the old corporation, profits after taxes and depreciation would have been less than $400,000. Instead, respondents received over $650,000 in installment payments during the same period, illustrating the substantial "cushion" given them by their sale [R. p. 56].

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[18] *Commissioner v. Duberstein,* 363 U. S. 278 (1960); *Rudolph v. United States,* 370 U. S. 269 (1962); *United States v. Yellow Cab Co.,* 338 U. S. 338 (1949); *Timken Roller Bearing Co. v. United States,* 341 U. S. 593 (1951); *Austin v. Commissioner,* 298 F. 2d 583 (2d Cir. 1962); *Commissioner v. Goodwyn Crockery Co.,* 315 F. 2d 110 (6th Cir. 1963); Fed. R. Civ. P. 52(a); Int. Rev. Code § 7482(a).

[18a] The Government mythology of an inevitably exorbitant price for these transactions may be traceable to an article by Geoffrey J. Lanning, *Tax Erosion and the "Bootstrap Sale" of a Business,* 108 U. of Pa. L. Rev. 623 (1960). Mr. Lanning was one of the Commissioner's counsel before the Tax Court in the *Kolkey* case, and was no doubt repelled by the highly

2. The Other Cases on Similar Facts Also Demonstrate the Unrealistic Nature of the Assumptions Upon Which Petitioner Relies, Since Despite the Presumption of Correctness Enjoyed by the Commissioner's Contrary Determinations, the Triers of Fact Have Rarely Found Grossly Excessive Purchase Prices.

Petitioner's theoretical arguments based on his erroneous analogy can be refuted not only by the facts of the present case, but by similar factual determinations in numerous other cases involving similar transactions. If petitioner were correct in his views, one would anticipate that the reports would be full of instances of sham negotiations and grossly excessive purchase prices—particularly since the Commissioner enjoys the litigating advantage of a presumption that his determinations are correct. Despite petitioner's theories, he has cited (and we know) only one instance where a seller *was* held to have "sold" for a grossly excessive and unrealistic price, and in that one case both the Tax Court and the Court of Appeals denied long-term capital gain treatment to the purported seller. *Kolkey v. Commissioner,* 254 F. 2d 51 (7th Cir. 1958). In most of the cases, in fact, the price was expressly found to be within a reasonable range, or not grossly excessive. The facts of these cases stand in glaring contrast with the conclusion demanded by petitioner's theorizing.

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sordid facts of that case. This may explain his firm moral conviction and that of petitioner here (in the face of all the facts) that other sales to charities are all only *Kolkeys* in more artful disguise. See, *e.g.,* Br. p. 25, Pet. pp. 20, 33. Thus Lanning seems to attribute all factual findings which run counter to his mythology either to the mistakes of Government counsel or the error of the lower courts. Lanning, *supra,* at pp. 642, 646. Since he wrote, there have been a number of similar cases involving realistic prices, including this one, but the Government by now appears too firmly wedded to its myth to be shaken by any number of mere facts.

In *Ohio Furnace Co.,* 25 T. C. 179 (1955) (Reviewed), a case in which the tax exemption of the purchasing Foundation was challenged but the tax treatment of the seller was not in issue, the Court stated that

> "the price paid for the stock in our opinion appears to have been reasonable, and the respondent does not contend otherwise. . . . Inasmuch as the investment in the Furnace Company stock was a sound investment and the price was fair, the payments from the Foundation's income to the sellers of the Furnace Company stock did not constitute an inurement of the Foundation's income to them but was (sic) the consideration in a purchase of stock for value received." (25 T. C. at 189.)

In *Knapp Bros. Shoe Mfg. Corp. v. United States,* 142 F. Supp. 899 (Ct. Cl. 1956), the price was $5,100,000 payable out of earnings, or about 5½ times the company's 1947 after-tax profits of $908,792. The Court held the purchasing "feeder corporation" exempt. Not only was the price fair and reasonable, but ". . . the purchase was a great bargain." 142 F. Supp. at 902. Within three and one-half years, the feeder, which was capitalized at $1,000, had paid out of income the entire purchase price with interest, including a down payment which it borrowed from a bank, and had even paid the Federal taxes erroneously assessed against it by the Commissioner.

In *Estate of Ernest G. Howes,* 30 T. C. 909 (1958), *aff'd sub nom. Commissioner v. Johnson,* 267 F. 2d 382 (1st Cir. 1959), the Tax Court, holding the seller to be entitled to capital gain treatment, and the purchasing feeder corporation exempt, stated:

> Suffice it to say, after a careful consideration of record, . . . we are satisfied that the total contract price . . . was fair and just, and was arrived at through arm's-length dealings between the parties. (30 T. C. at 923.)

On appeal, the Commissioner relied upon the same grounds here urged—that there was no infusion of new funds and no risk of capital.

The Court of Appeals observed:

> Even though this be so, this factor is of minor significance for often purchases are financed by mortgages taken back by the seller. In such an event a real risk is borne by the mortgagee but this does not cause an otherwise valid sale to become something less than that. (267 F. 2d at 385.)

The interesting thing to note is that a fair price *was in fact* negotiated, despite this continuation of economic risk—demonstrating once more that the cushion provided by the exempt purchaser's added earning power produces *in practice* the economic equivalent of an independent infusion of risk capital, and makes possible, contrary to petitioner's theory, an arm's length sale at a "fair and just" purchase price.

In *Anderson Dairy, Inc.,* 39 T. C. 1027 (1963), the taxpayers sold their partnership business to University Hill Foundation for $1,000,000 and sold associated real property for $250,000, with a down payment of $15,000 and on terms otherwise quite similar to those in the case at bench. In the same year an independent profit-making corporation, Beatrice Foods, had at arm's length tentatively offered to buy the business at the same price of $1,000,000 (excluding the real property, which was valued by the seller at $300,000), but other problems made this sale impracticable. 39 T. C. at 1029-30. The Tax Court found as a fact that the *cash* fair market value of the property transferred was $945,000 (or 73% of the agreed installment sales price). 39 T. C. at 1034. Since it was provided that payments were to be made without interest over a ten-year period, it seems clear that, as in the case at bench, most or all of the 27% spread between cash value and the time sales price was well within line as a reasonable time-price differential. The Tax Court held "the final purchase price was the result of real negotiations" and that "the price paid by the Foundation was not grossly excessive." 39 T. C. at 1042.

In *Royal Farms Dairy Co.*, 40 T. C. 172 (1963), the taxpayers in 1953 sold their stock in Royal Farms Dairy Co. ("Royal #1") to University Hill Foundation for a price of $2,680,000, payable $10,000 down and the balance over not more than ten years, without interest, on terms similar to those at bench. Again, the Tax Court rejected the Commissioner's claim on an excessive price, finding:

> "The fair market value on July 31, 1953 of Royal #1 as a going business exceeded $2 million and was not substantially different from the price set in the sales agreement." (40 T. C. at 183.)

and that (as in Clay Brown):

> "Here, the price 'was within a reasonable range in light of the earnings history of the corporation and the adjusted net worth of the corporate assets.'" (40 T. C. at 185.)

Even the *Commissioner's* witness placed the cash value at 78% of the actual installment sales price (40 T. C.

at 185 n.6). If this valuation be accepted, the 22% spread again represents no more than a reasonable time-price differential.

In *Ralph M. Singer,* P-H T. C. Mem. ¶63,158, 22 CCH T. C. M. 759 (1963), the taxpayer sold stock in three companies to University Hill Foundation, for prices of $1,233,335, with nothing down (Lakeview); $210,000, with 16.7% down (Clark); and $2,997,000, with 7.3% down (Trinity). On the Trinity sale, the only one in which the question of unreasonable price was discussed, the Tax Court carefully considered the asset values and concluded that "the final purchase price was not grossly excessive."

In *Isis Windows, Inc.,* P-H T. C. Mem. ¶63,176, 22 CCH T. C. M. 837 (1963), the taxpayers on June 16, 1952 agreed to sell to University Hill Foundation all the stock of Steel Window Corporation, for $235,000, ($10,000 down) and certain real property for $40,000. The terms were again similar to those in the current case, with non-interest bearing installment payments. Within a mere two and one-half years the entire purchase price had been paid by the Foundation from the earnings of the business. Once again, the Court found the price to be "within a reasonable range in the light of the earnings history of the corporation and the adjusted net worth of the corporate assets."

In *Oscar C. Stahl,* P-H T. C. Mem. ¶63,201, 22 CCH T. C. M. 996 (1963), University Hill Foundation agreed to pay a price of $820,000 ($1,000 down) for the taxpayers' stock in American Extruded Products Co. This figure represented about 3¾ or 4 times the anticipated before-tax earnings of $200,000 to $225,000 for the year of the sale. (Actual earnings for that year proved to be $287,773.11.) Substantially full payment was made within five years. The Court stated that "Under the circumstances we do not think the $820,000 purchase price was so unreasonable as to prove or even indicate that the agreement was other than what it purported to be."

In *Estate of James L. Hawley,* P-H T. C. Mem. ¶61,038, 20 CCH T. C. M. 210 (1961), the taxpayer and others sold their stock in Hugh H. Eby, Inc. for $2,500,000 to an exempt Institute. Judge Raum, who was later to dissent in the present case, made no express findings as to value and noted that it was a close case, but that on all the evidence it was a true sale (not like *Kolkey,* as to which case Judge Raum said "the Court felt that the transaction . . . was a sham.")

In *Estate of Cordie Hawthorne,* P-H T. C. Mem. ¶60,146, 19 CCH T. C. M. 770 (1960), the taxpayers sold their stock to a church for $3,128,617.72, payable in minimum annual installments of 10% of corporate sales. The Court stated that the price "was apparently a fair evaluation of the asset they disposed of." The Commissioner did not argue that the price was grossly excessive, and the court found that the sale price "appeared to be a reasonable amount" "to all parties to the transaction."

In *Union Bank v. United States,* 285 F. 2d 126 (Ct. Cl. 1961), the trial commissioner found $1,174,006.23 to be the fair value of business assets sold to charity for book value plus $2,050,000. Although in this case the purchase price exceeded cash value, the Foundation made a down payment of $100,000, evidencing its bona fide expectation of completing payment out of earnings and apparently payment was so completed in ten years. The Court of Claims held that despite the relatively high price the transaction was a bona fide sale.

The present case and the above eleven other cases are the only cases known to us involving transactions of the general type here in question in which the Courts found bona fide sales to have occurred.[19] In at least ten of these twelve cases the findings of fact regarding value mock the government's theoretically-oriented contentions.[20] In all twelve of the cases the intent was to sell the stock and the price was arrived at in good faith negotiations centering on true value. The findings of the Court in the present case were therefore typical, and not a mere inexplicable aberration. Since only an irrational seller would sell at a price within a reasonable range if the sale was truly characterized by the inordinate risks and absence of acceleration of payment of petitioner's theoretical model, the existence of numerous sales of this type at realistic prices proves that in the hardheaded evaluation of the market place, the risks of such a transaction are not in practice deemed inordinate and that these sales are customarily treated like any other installment sales. The results indicate that charities are not in practice as bereft of bargaining power as petitioner would have the Court believe. The facts of other cases, as of this one, preclude the arbitrary denial of long-term capital gain treatment on petitioner's theoretical grounds.

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[19] In *Warren Brekke,* 40 T. C. 789 (1963), the seller was not before the Court, and the issue was limited to deductibility by the operating company of rental payments made to the charity for the former assets of Weiser Company. The Court found that the rental payments were not in excess of a fair rental, but held the sale (and thus the lease) not to have been bona fide, in part because the purchase price was found to be almost double fair value. The taxpayer presented no evidence on the fair value of the stock because in his view of the case the only issue was the reasonableness of the rents. However, it is his position on appeal that the finding on value was clearly erroneous, particularly since full payment was made out of earnings within 3½ years.

[20] Possible exceptions are *Estate of James L. Hawley, supra* and *Union Bank v. United States, supra.* Even there, however, the negotiations were genuine and bona fide sales clearly intended by both parties.

Finally, the lower Courts have amply demonstrated their ability to distinguish the true negotiated sale situation from the "sham" case where a price *is* as grossly in excess of fair value as petitioner seems to feel all non-down payment, non-recourse sales to charity must be. In *Emanuel Kolkey, supra,* where the "purchase" price was over three times fair market value, both the Tax Court and the Seventh Circuit Court of Appeals had no difficulty holding the transaction not to be a genuine sale. *Cf. Evans v. Rothensies,* 114 F. 2d 958 (3d Cir. 1940). Taxpayers are not entitled to a rule of law that automatically sanctifies *every* purported sale to a charity, and *Kolkey* always stands guard against abuses. By the same token, the petitioner has no legitimate right to seek from this Court, as he does, a holding that as a matter of law, a non-recourse, non-down payment sale to a charity will not be recognized for tax purposes—however genuine the negotiations, however reasonable the price, and however clear the intent of the parties. If the petitioner feels such a rule is desirable, his remedy must be with the legislature.

II.

THE TRANSACTION IN QUESTION CONSTITUTED A SALE WITHIN THE MEANING OF CODE SECTION 1222(3).

A. The Gains in Question Fit Precisely Within the Central Core of the Type of Gains From Disposition of a Capital Asset for Which Long-Term Capital Gain Benefits Were Designed.

1. Respondents' Final and Unequivocal Conversion of Capital Assets Into a Substantially Different Form Was a Realizing Transaction.

The above demonstration of the theoretical and factual fallacies in petitioner's approach to the definitional question in this case would not by itself affirmatively prove a "sale" within the meaning of Code Section 1222(3). However, once these fallacies have been eliminated, and the transaction recognized for what the trier of facts found it was—a good faith arm's length disposition of stock at a negotiated price within a reasonable range—the transaction is demonstrably a "sale" as this and other Courts have always construed the term.

Not only is the Commissioner's solution to this problem based upon erroneous postulates, but it would do violence to one of the most deeply-embedded and thoroughly-settled axioms of the tax law—the concept of realization. When the Commissioner's straw man argument is disposed of, there remains of his contention (Br. p. 27) only the argument that a "sale" cannot occur without the shift of the primary business risks from seller to buyer, and the related argument that there can be no "sale" where the amount or the timing of the payments are dependent upon subsequent profits. However, these arguments are untenable, as a review of basic principles and the decided cases will demonstrate.

On September 30, 1946 Clay Brown and his family acquired 30,000 shares of stock of Clay Brown & Company, an Oregon corporation, for $30,000. By 1953 due to the substantial accumulated tax-paid corporate earned surplus and the demonstrated corporate earning power, the value of the stock had appreciated to about $1,175,000 [R. p. 64].[20a] The Browns' annual increments of value of the stock went currently untaxed, however, because the American taxing system does not treat mere accrued gains in value as current income, but rather waits for an event which changes the nature of the taxpayer's interest in some sufficiently consequential manner to be noticed by the tax law, and on the occurrence of such a conversion taxes the total accrued gains at one time. *Eisner v. Macomber,* 252 U. S. 189 (1920).

Such a realizing event, when it involves a reciprocal complete disposition of legal property interests with another legal entity is an "exchange." *Helvering v. William Flaccus Oak Leather Co.,* 313 U. S. 247, 249 (1941). An exchange (and therefore a realizing transaction) occurs whenever a capital asset is converted into some significantly different asset. For example, in the early landmark case of *Marr v. United States,* 268 U. S. 536 (1925), this Court held that gain was realized by a General Motors stockholder when that corporation was merely reorganized from a New Jersey to a Delaware corporation, and the taxpayer's New Jersey shares were exchanged for Delaware shares representing the identical underlying business and assets. Mr. Justice Brandeis said:

[20a] This includes the price paid for a small number of shares owned outside the family which are ignored here for simplicity.

> The government insists that identity of the business enterprise is not conclusive; that gain in value resulting from profits is taxable as income, not only when it is represented by an interest in a different business enterprise or property, but also when it is represented by an essentially different interest in the same business enterprise or property; that, in the case at bar, the gain actually made is represented by securities with essentially different characteristics in an essentially different corporation; and that, consequently, the additional value of the new securities, although they are still held by the Marrs, is income under the rule applied in United States v. Phellis, 257 U. S. 156, 42 S. Ct. 63; Rockefeller v. United States, 257 U. S. 176, 42 S. Ct. 68; and Cullinan v. Walker, 262 U. S. 134, 43 S. Ct. 495. In our opinion the government is right. (268 U. S. at 540.)[21]

In other words, termination of business risk, as such, has nothing to do with whether a transaction is a realizing transaction.

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[21] Today, gain realized on such a transaction would not be *recognized,* by virtue of §§ 354 and 368(a)(1)(F). This does not weaken the validity of the principle of realization or change the character of the transaction as an exchange. The nonrecognition provisions are construed strictly, and must be met both in letter and in spirit. *Gregory v. Helvering,* 293 U. S. 465 (1935); *LeTulle v. Scofield,* 308 U. S. 415 (1940); *Turnbow v. Commissioner,* 368 U. S. 337 (1961); *Bazley v. Commissioner,* 331 U. S. 737 (1947). For example, there would be a recognition of gain on such a transaction if one of the corporations was a foreign corporation and no advance ruling was obtained under § 367. *Cf. Texas-Canadian Oil Corp.,* 44 B. T. A. 913 (1941).

A "sale" is merely a special form of exchange in which the other party delivers or agrees to pay cash, instead of other property, for an asset. A sale, like any other exchange, is a realizing transaction, on which the accumulated increments of value over the prior years are recognized because of their conversion into something different, *i.e.,* cash or notes evidencing the right to cash. See *Merchants' Loan & Trust Co. v. Smietanka,* 255 U. S. 509 (1921); *Hays v. Gauley Mountain Coal Co.,* 247 U. S. 189 (1918); *United States v. Cleveland, C., C. & St. L. Ry.,* 247 U. S. 195 (1918); *MacLaughlin v. Alliance Insurance Co.,* 286 U. S. 244 (1932); *Jordan Marsh Co. v. Commissioner,* 269 F. 2d 453, 456 (2d Cir. 1959). The degree of risk and uncertainty surrounding the cash to be received may affect the year of recognition. *Burnet v. Logan,* 283 U. S. 404 (1931). They do not alter the *fact* of recognition or the characterization of the transaction as a *sale. LeTulle v. Scofield,* 308 U. S. 415 (1940).

The doctrine of realization has been said to be "one of the two or three significant contributions of the Supreme Court in the field of income taxation . . ." Magill, *Taxable Income,* 47 (Rev. Ed. 1945). It is basic and fundamental, and (at least since certain contrary dicta in *Lynch v. Turrish,* 247 U. S. 221, 229-230 (1918) were impliedly overruled by *Merchants' Loan & Trust Co. v. Smietanka, supra*) this Court has never failed to hold that gain is realized on the occurrence of such a transaction. In fact, if anything, this Court has become even readier to find that realization of income has occurred. Compare *Helvering v. Bruun,* 309 U. S. 461 (1940) *with Eisner v. Macomber,* 252 U. S. 189 (1920).

The structure of the Code provisions on this point is clear. Whenever an asset which has appreciated in value is disposed of for cash, a right to cash, or any other property, gain is realized. Sections 1001(a); 1001(b). Except as expressly provided in one of the various nonrecognition provisions of the income tax subtitle, this gain must be recognized and included in the taxpayer's gross income for the year of realization under Section 61(a)(3). Section 1002; *Turnbow v. Commissioner,* 368 U. S. 337 (1961).

The long-term capital gains provisions are a corollary of this doctrine of realization. Their principal purpose is to avoid "bunching" at ordinary rates in the year of the realizing event—the "sale or exchange"—of all of the previously accrued but hitherto unrealized gains of prior years.[22] Where there are gains on the realizing conversion of a capital asset into cash, they will be capital gains. To hold otherwise, at least in a good faith bargained transaction at a realistic price, is to deprive the taxpayer of the tax treatment Congress clearly intended, and to award an unintended windfall to the Government.

In 1953 the Browns entered into the transactions here in question. They transferred their stock and notes to the Institute, which agreed to and did immediately liquidate the corporation, and gave respondents in exchange for the stock and notes its note for $1,300,000 maturing in ten years, and secured in effect by first liens on all of the former corporation's assets. The transaction was admittedly genuine and not a "sham" (Br. p. 37). Although petitioner, as we have seen, argues the case as though the stock was transferred with a retained right to "dividends," there was no such right. A liquidated corporation declares no dividends. There was rather a clear conversion of the form of the respondents' investment, and therefore a realizing transaction.

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[22] See, *e.g., Commissioner v. Gillette Motor Transp. Inc.,* 364 U. S. 130, 134 (1960); *Commissioner v. P. G. Lake, Inc.,* 356 U. S. 260, 265 (1958); *Helvering v. Hammel,* 311 U. S. 504, 509 (1941); *Burnet v. Harmel,* 287 U. S. 103, 106 (1932).

2. Since Realization Occurs Even Where the Taxpayer Remains Dependent Upon and at the Economic Risk of Subsequent Declines in Earnings and Asset Values of the Income-Producing Asset Transferred, Such Continued Dependency and Risk Are Not Reasons for Denial of Long-Term Capital Gain Treatment on the Realized Gains.

Petitioner does not, apparently, rely on any contention that the sale qualified for nonrecognition under any of the nonrecognition provisions of the Code.[23] His theory is basically that because business risks continued to jeopardize receipt of the full $1,300,000, the transaction was not a realizing transaction at all, but the mere retention of an income interest, similar to that in *Burnet v. Harmel,* 287 U. S. 103 (1932) (Br. p. 45). The implication is that a substantial shift of business risk is a prerequisite to realization (Br. p. 37).

There are two compelling answers to this contention. First, even if a substantial shift of business risk *were* required, the requirement is easily satisfied in this case, as we have seen.[24] Secondly, and more fundamentally, no substantial shift of risk is required either for realization or for capital gain treatment. The Courts, notably including this Court, as well as Congress and even the petitioner himself, have repeatedly recognized that realization of gain on sales and exchanges does not require the taxpayer's freedom from the economic hazards associated with his original position. Such gains are even realized through mere shifts in the form of ownership of assets, without any hint of "shifting of the benefits and burdens of future gains and losses to others" or "relinquishment of the future for the present," to use petitioner's terms (Pet. p. 13). Thus, in *Marr v. United States, supra,* the shift of a corporate charter from one state to another was held to constitute a realizing exchange. In *Cullinan v. Walker,* 262 U. S. 134 (1923), the Court similarly held that gain was realized on a divisive reorganization in which the taxpayer in effect exchanged his stock in one corporation for stock and bonds in newly-formed corporations, with no "cashing in," or "relinquishment of the future for the present," but merely an altered form of ownership of the identical businsses and assets previously held through the original stock. The simplest case of such a realizing exchange, of course, is an ordinary corporate liquidation. Even if the stockholders of the corporation will immediately continue the same business in partnership or other form—remaining subject to all the business risks—it is clear that a realizing exchange has occurred, as long as the liquidation is genuine.[25] Similarly, the mere exchange of business assets for stock on the formation of a corporation is a clear realizing transaction, and only Section 351 (where it applies) prevents recognition of gain thereon.

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[23] It is suggested at one point that there might have been a corporate reorganization (Br. pp. 73-74). *LeTulle v. Scofield,* 308 U. S. 415 (1940), squarely in point, suffices to rule out any such contention.

[24] See pp. 21-23 above.

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[25] See, *e.g., Hellmich v. Hellman,* 276 U. S. 233 (1928); *United States v. Arcade Co.,* 203 F. 2d 230 (6th Cir. 1953); *Wessel v. United States,* 49 F. 2d 137 (8th Cir. 1931); Code § 331(a)(1).

The absence of any prerequisite of shift of business risk was made particularly clear by this Court in *LeTulle v. Scofield,* 308 U. S. 415 (1940). In that case, the taxpayer conveyed certain properties to his wholly-owned corporation, which then exchanged these assets and others which it had previously held with a new corporation for $50,000 in cash, and $750,000 in bonds of the new corporation payable serially over 10 years. The new corporation had little capital and the bonds would only be paid if the business succeeded, and were secured solely by the assets transferred. Upon default, the bondholders would retake only the property sold. *Scofield v. LeTulle,* 103 F. 2d 20, 22 (5th Cir. 1939). The taxpayer's old corporation was then liquidated. The Court of Appeals for the Fifth Circuit held that this transaction qualified in part as a tax-free reorganization, advancing the very grounds for characterizing it as something other than a "sale" which the Government now urges on this Court—*i.e.,* the down payment was minimal, and the bonds would only be paid off if the business succeeded, so that there had assertedly been an insufficient shift of business risk to cause recognition of the taxpayer's gains. 103 F. 2d at 22. This Court, however, disagreed, holding that despite the clear continuation of business risks by the sellers, the transaction was a "*sale or exchange upon which gain or loss must be reckoned in accordance with the provisions of the revenue act dealing with the recognition of gain or loss upon a sale or exchange*" 308 U. S. at 421 (Emphasis added.)

In *Bull v. United States,* 295 U. S. 247 (1935), this Court cited with approval two earlier Court of Appeals cases which treated as sales transactions in which the interests of deceased partners were sold to their surviving partners, or the partnership, in exchange for payments to the estate by the surviving partners of amounts measured solely by post-death partnership earnings.[26] This Court said, citing these cases:

> Where the effect of the contract is that the deceased partner's estate shall leave his interest in the business and the surviving partners shall acquire it by payments to the estate, the transaction is a *sale,* and payments made to the estate are for the account of the survivors (295 U. S. at 254; Emphasis added).

In *Vermont Transit Co., Inc. v. Commissioner,* 218 F. 2d 468 (2d Cir. 1955), *cert. denied,* 349 U. S. 945 (1955), the taxpayer agreed to purchase certain franchises, with part of the consideration to consist of earnings from the franchises during the ensuing five-year period. This consideration was held to be part of the purchase price and not a mere retention by the seller of earnings, so that the buyer was required to include these amounts in his income. The Court said:

> Whether an agreement of purchase and sale has conveyed all of the property interests involved so as to make the purchaser fully taxable on all of the resultant earnings or whether the contract has reserved an interest in the seller on which the seller is taxable is a question of the intent of

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[26] *Hill v. Commissioner,* 38 F. 2d 165 (1st Cir. 1930); *Pope v. Commissioner,* 39 F. 2d 420 (1st Cir. 1930); cited 295 U. S. at 254. To the same effect is *McKelvey v. Commissioner,* 246 F. 2d 609 (3d Cir. 1957).

> the parties in making the agreement. This intent may be inferred from the wording of the agreement and from the surrounding circumstances. Thomas v. Perkins, 301 U. S. 655, 447 S. Ct. 911, 81 L. Ed. 1324; Anderson v. Helvering, 310 U. S. 404, 60 S. Ct. 952, 84 L. Ed. 1277. We agree with the conclusion of the Tax Court that the facts here point to the outright sale of a capital asset without reservation of interest (218 F. 2d at 469-470).

In *Nordberg Mfg. Co. v. Kuhl*, 16 F. 2d 331 (7th Cir. 1948), it was held that an arrangement under which dividends, if any, were to be applied to the liquidation of taxpayer corporation's preferred stock constituted a capital transaction (in effect a sale) and not a distribution of the corporation's earnings, so that the taxpayer received no dividend credit. *Cf. Hellmich v. Hellman*, 276 U. S. 233, 236-37 (1928); *Ayrton Metal Co. v. Commissioner*, 299 F. 2d 741, 748 (2d Cir. 1962); *Commissioner v. Ferrer*, 304 F. 2d 125, 131 (2d Cir. 1962).

Congress, too, has recognized the same principle. As recently as January, 1964, the Senate Finance Committee, in the following words, gave express recognition to the principle that there can be a sale or exchange of property even though payments depend on future income derived therefrom:

> Where, at the time of the *sale or exchange*, some or all of the payments are indefinite as to their size; *for example where the payments are in part at least dependent upon future income derived from the property*, the 'unstated' interest for purposes of this provision will be determined separately with respect to each indefinite payment as it is re-

> ceived, taking into account the time interval between the sale or exchange and the receipt of the payment. S. Rep. No. 830, 88th Cong., 2d Sess. 103 (January, 1964) (emphasis added).

To identical effect is H.R. Rep. No. 749, 88th Cong., 1st Sess., 73 (1963).

This language referred to what is now Code Section 483(d), providing for imputed interest on "Payments That Are Indefinite as to Time, Liability, or Amount." Instead of providing for 100% ordinary income treatment, Congress was content in Section 483(d) to prevent capital gain treatment only for so much of these payments as constituted disguised interest. Congressional judgment *not* to treat such payments as 100% ordinary income, but only so to tax the imputed interest element, was clearly deliberate since the Secretary of the Treasury, at the time he requested Congress to enact legislation imputing interest on deferred payment sales (now Section 483), also asked Congress to provide ordinary income treatment for "payments on the sale of a capital asset (or payments so treated under present law) which are deferred over more than 5 years and are contingent on future income." *Statement by Secretary of the Treasury and Technical Explanation on President's Tax Reduction and Reform Message, Before House of Representatives Ways and Means Committee,* February 6, 1963, p. 91. The Secretary there conceded what petitioner (Br. p. 60) *now* denies.

> Under present law, capital gain treatment is sometimes available on the sale of an asset even though the seller retains an interest in the income that is produced by the asset. In such cases the taxpayer is able to continue to enjoy the principal

right of ownership—participation in the income produced by the asset—but is taxed at capital gains rates as if he had completely parted with ownership. In the case of contracts for the sale of such assets made after February 6, 1963, where the seller retains a long-term income interest, the proposal would treat as ordinary income, payments contingent on future income from the asset sold, or from the income-producing property underlying the asset sold. A payment would be regarded as so contingent on future income if it were contingent on productivity, sales, profitability, use or disposition of the asset sold or the underlying property. For example, the proposal would cover the sale of stock in a corporation where payment is contingent on dividends on the stock or productivity of the corporate assets.

. . . .

"Example 1

S owns all of the stock of M Corporation. The stock has an adjusted basis of $75,000 in S's hands. S sells the stock to P for $50,000 cash plus $300,000, payable only out of 75 percent of M Corporation's net profits in excess of the first $50,000 of such net profits. Under present law, assuming S would be entitled to cost recovery, he would offset his basis against the down payment and the first $25,000 of contingent payments and would receive capital gains treatment with respect to all subsequent payments. (Secretary's Statement at pp. 91-92.)

Had Congress desired to comply with the Secretary's request, it would have done so. Instead, it provided the more limited provisions of Section 483(d). The situation in the present case could not be clearer. The petitioner expressly called to the attention of Congress the fact (which for his then purposes he unqualifiedly admitted) that 100% capital gain treatment was permitted where an asset is sold for a price contingent on earnings, and he requested Congress to substitute 100% ordinary income treatment. Congress considered the problem and responded with Section 483(d), which treats as ordinary income *only* the portion of such gains which constitutes imputed interest. Petitioner now asks this Court to do for it what Congress would not. So presumptuous an invitation to judicial legislation should be ignored. See *Hanover Bank v. Commissioner,* 369 U. S. 672 (1962), in which this Court said:

> With particular relevance to the Government's argument in the instant case, it is worthy of note that Congress understood the operation of the statute to the taxpayer's advantage, but limited correction of the abuses inherent in it to elimination of the quick write-off. (369 U. S. at 684.)

The decision made by this Court in *Hanover Bank* was, quite properly, to leave the legislating to Congress, even though the taxpayer in that case admittedly received something of a windfall. How much more the same decision should be reached in a case such as this where (because of the realistic price) the taxpayer claims *no* tax benefits not available on *any* installment sale and where it is the *Government* which demands a windfall through judicial legislation.

Congressional action in expressly providing that not even a *nominal* down payment is required in the year of sale for application of the installment sales provisions further indicates Congressional disagreement with the petitioner's thesis here.[26a] Sales with no down payment are not in practice usually made where the purchaser has substantial independent assets—if he had them he would use them to make a down payment. Even the Service was always satisfied with a ***nominal*** down payment. G. C. M. 12148, XII-2 C. B. 57 (1933).

Even the Commissioner does not customarily contend that a complete disposition of an asset is not a sale merely because the cash payments are at risk or are contingent on the productivity of the asset transferred. Thus he acquiesced, 1960-2 C. B. 7, in the Tax Court's opinion in *W. H. Truschel,* 29 T. C. 433 (1957). In this case the petitioners, stockholders of Pocahontas Tanning Company, sold their stock to a "feeder corporation" for short-term notes and bonds of the feeder, into which Pocahontas was merged. The Commissioner pointed out that because the feeder had only $1,000 of capital soock and $22,000,000 of bonds, the bonds were entirely at the risk of the business. Contending that this made the bonds the equivalent of equity, despite the fixed maturity date and fixed rate of interest, the Commissioner argued the transaction was not a sale but a reorganization. The Court, relying on *LeTulle v. Scofield, supra,* held it was a sale, resulting in long-term capital gains to the selling shareholders. Petitioner's published acquiescence in this case, which is still of record and has not been withdrawn, demonstrates his agreement with the proposition that a sale is nonetheless a sale, and nonetheless entitled to long-term capital gain treatment, even in the absence of independent risk capital and despite the continuation of business risk.

[26a] *Compare* G. C. M. 12148, XII-2 C. B. 57 (1933) and Treas. Reg. § 39.44-2(c) under Section 44(b) of the 1939 Code, *with* Section 453(b) of the 1954 Code. See S. Rep. No. 1622, 83rd Cong., 2d Sess. 64 (1954).

In a recent Revenue Ruling, the Commissioner considered the case of a donation of a remainder interest in property to charity, with a life estate retained in the income from the property. Because the terms of the transaction required the immediate disposition of the property by the charity in a realizing transaction and the conversion of the proceeds into other assets, the Commissioner expressly held that the transaction constituted not the mere retention of an income interest, but a realizing and recognizing sale or exchange. Rev. Rul. 60-370, 1960-2 C.B. 203. We see absolutely no tenable distinction between this transaction and the one before this Court on the basis of which it could be argued that the former was a realizing exchange and the present case a mere reserved income interest.

Similarly, in Rev. Rul. 58-353, 1958-2 C.B. 408, the Commissioner indicated his agreement with the now well-settled principle that a patent assignment constitutes a sale for tax purposes despite payments measured by the productivity of the transferred asset and payable over a period generally coterminous with its use. This is particularly embarrassing to the Commissioner in the present case because this case is a much clearer one for capital gains treatment, in that it involves a *fixed* sales price, payable over a relatively *short* period, for an asset which (unlike a patent) was *not* inherently exhaustible. Certainly the repeated rebuffs in the patent area to the Commissioner's theories—both from the courts and the legislature—have pained him, and this court has already had occasion to comment upon his "obduracy" in these matters. *United States v. Zacks,* 375 U. S. 59, 69-70 (1963). However, the Commissioner having finally published his agreement with the conclusions of the courts, it is a bit surprising to read in his brief (pp. 68-69; & n.41) that the cases relied on in Rev. Rul. 58-353 are "wrong in principle" and that the Ruling merely meant the Service "was forced to cease litigating the question, at least for the time being." This is particularly true since the Commissioner *sua sponte* subsequently extended the principle of Rev. Rul. 58-353 into the copyright area, without citing any copyright cases forcing such a decision, Rev. Rul. 60-226, 1960-1 C.B. 26, and since as recently as February, 1963 the Secretary of the Treasury officially reiterated this understanding of the law and requested *non-retroactive* legislative correction—which Congress refused.[27] We had thought that Rev. Rul. 58-353 represented more than a temporary surcease of the Commissioner's "obduracy" in the patent field, and that this question was well laid to rest.[28] Be that as it may, there is no need to consider the patent cases further since there is little resemblance between the typical patent assignment and the present sale of stock for a fixed cash price within a reasonable range.

On the basis of the above-cited authorities, it is clear that the dispositions by respondents of their stock in

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[27] *Statement by Secretary of the Treasury and Technical Explanation on President's Tax Reduction and Reform Message, Before House of Representatives Ways and Means Committee* (February 6, 1963) pp. 91-92.

[28] Despite petitioner's position in this case, neither Rev. Rul. 58-353 nor Rev. Rul. 60-226 have been rescinded and numerous taxpayers enter daily into long-term transactions in reliance upon them. See also Rev. Rul. 62-81, 1962-1 C. B. 153.

Clay Brown & Co. on February 4, 1953 constituted sales. There was at that point of time a shift in the rights of the respondents of fully sufficient substantiality to satisfy the doctrine of *Marr v. United States, supra* (in which the shift was much less than that in the case at bench). Before the sales, respondents owned stock in a going Oregon corporation. This was irrevocably surrendered to the Institute in return solely for a right to cash, and cash was all that respondents got. Moreover, as an essential and agreed part of the transaction the corporation was liquidated [R. pp. 198-199]. This liquidation *alone* would have sufficed to produce both realization and recognition of the entire accumulated gain at long-term capital gain rates, even if the assets of the liquidated corporation had been *retained* by respondents. Since none of these assets were retained, but instead became the property of the Institute, while respondents received only a cash down payment and the Institute's promissory notes, it is even clearer that a realizing transaction, and a sale, took place. The above authorities adequately demonstrate that this is true, regardless of the extent to which payment of the notes depends on the subsequent success of the underlying business enterprise.

Furthermore, to gloss over the corporate liquidation in this case and treat the transaction as if a right to dividends on the stock *were* retained, rather than the right to payment of $1,300,000 in installments equal to 90% of the income (before taxes and depreciation) to be earned by rental of the business and assets of the former corporation, completely ignores the existence of the corporate entity—the difference between stock and assets. It ignores the distinction drawn in the very oil and gas cases on which petitioner primarily relies between the *retention* of a reserved royalty right when the taxpayer transfers the remainder of his lease rights (*not* a realizing transaction), and the *sale* of stock in a corporation, even if payment therefor is to be made in cash measured by the productivity of the corporate assets (a realizing transaction). Compare *Burnet v. Harmel,* 287 U. S. 103 (1932) with *Helvering v. O'Donnell,* 303 U. S. 370 (1938). This Court held in *O'Donnell* that since the taxpayer sold stock, not oil in place, he was not selling (and could not be reserving any depletable interest in) the underlying corporate assets. Thus the liquidation in this case stands as an impenetrable barrier to the petitioner's "reserved income" theory. The barrier is the corporate entity itself, which may not simply be ignored for tax purposes to suit the convenience of either party. *Moline Properties, Inc. v. Commissioner,* 319 U. S. 436 (1943); *Burnet v. Commonwealth Improvement Co.,* 287 U. S. 415 (1932).

The fact that payments were made over a period of years does not weaken this argument, since it is only by virtue of respondents' exercise of their statutory privilege of reporting on the installment basis that they are permitted to spread their realized and recognized gains over the period of payment. Internal Revenue Code Section 453. A sale cannot be less a sale because this election is made. A sale or exchange is not in any event deprived of its capital nature merely because the gain or loss may be spread over a number of years. See, *e.g., Arrowsmith v. Commissioner,* 344 U. S. 6 (1952); Code Section 346(a)(1); *Sara A. Young,* 16 T. C. 1424 (1951); *Cf. Burnet v. Logan,* 283 U. S. 404 (1931).

Moreover, it is a well-settled principle that neither the government nor the taxpayer may focus on a single step and ignore the other steps in an integrated series of steps making one transaction.. *Helvering v. Alabama Asphaltic Limestone Co.,* 315 U. S. 179, 184-185 (1942); Mintz & Plumb, *Step Transactions in Corporate Reorganizations,* 12 N.Y.U. Tax Inst. 247 (1954). Thus, even if the transaction in question amounted merely to the retention of a right to dividends (as the government hypothesizes), if it had been immediately followed by a liquidation in accordance with a prearranged plan, the substance of the transaction would under this principle be treated for what it was by integrating the two steps. *A fortiori,* the government cannot properly break into two steps a transaction which, in fact, consisted of only one, in order to assess a tax on its theory of what the appropriate tax results would be on the first nonexistent and hypothetical step.

B. Any Economically Genuine Final Disposition of a Capital Asset for a Cash Price Constitutes a Sale.

1. The Term "Sale" Used in I.R.C. Section 1222 Should Be Given Its Normal Meaning.

Despite the frequency with which the term "sale" is used in the Code, it is nowhere expressly defined. As we have indicated, however, its use in the phrase "sale or exchange," and the fact that long-term capital gain treatment is a statutory corollary of the doctrine of realization, show that a sale is simply a realizing transaction in which an asset is transferred to another party in exchange for cash or the right to cash—in effect a particular category of exchange. Since the noncontinuation of risk has nothing to do with capital gain treatment on any other exchange, there is no good reason to read such a requirement into the definition of a sale.

Further support for this view is found in this Court's repeated holdings that "the words of statutes—including revenue acts—should be interpreted where possible in their ordinary everyday senses." *Hanover Bank v. Commissioner,* 369 U. S. 672, 687 (1962); *Crane v. Commissioner,* 331 U. S. 1, 6 (1947).[29] This principle applies to the term "sale or exchange" no less than to any other statutory language. *Helvering v. William Flaccus Oak Leather Co.,* 313 U. S. 247, 249 (1941).

The principle of giving words their normal meaning has been applied even where it resulted in unusual benefits to taxpayers. *E.g., Hanover Bank v. Commissioner, supra; Commissioner v. Korell,* 339 U. S. 619 (1950). It is even more clearly applicable where the normal meaning of the word "sale" is entirely in harmony with the statutory scheme and would give the taxpayers no unusual benefits, and where the contrary interpretation would provide a windfall to the government at taxpayers' expense. *Helvering v. Hammel,* 311 U. S. 504, 510-511 (1941); *Lewyt Corp. v. Commissioner,* 349 U. S. 237 (1955). The statutory intent of the long-term capital gains provision, as we have seen, is largely to moderate the "bunching" effect which would otherwise result from the inclusion of the entire gain in the income of the year of the realizing event.[30]

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[29] See *Commissioner v. Korell,* 339 U. S. 619, 627-28 (1950); *Lang v. Commissioner,* 289 U. S. 109, 111 (1933); *Lynch v. Alworth-Stephens Co.,* 267 U. S. 364, 369-70 (1925); *Old Colony R. v. Commissioner,* 284 U. S. 552, 560 (1932); *Cf. Braunstein v Commissioner,* 374 U. S. 65 (1963); *Gilbert v. United States,* 370 U. S. 650 (1962).

[30] See cases cited note 22.

In the present case, most or all of the bargained-for price, and certainly all of the $936,131.85 actually paid, represented return of respondents' basis and beyond that realization in cash of the very type of accretion in value over a period of years to which the long-term capital gains provisions were primarily intended to be applicable. In fact, the corporate book net worth alone (invested capital, notes, and corporate earned surplus) at the time of the transfer was $619,457.63 [R. p. 22], or 66.2% of respondents' total receipts. It follows that long-term capital gain treatment is demanded by the statutory purpose, and if the normal meaning of "sale" includes the present transaction this Court should not characterize it as something else. This is particularly true where the petitioner's recommended characterization—"retention of an income interest"—is not only inconsistent with the statutory purpose and the commonly accepted meaning of "sale," but also as we have seen does such violence to the basic doctrine of realization.

Still further reason for the application of the normal meaning of the words is found in that Congress was fully aware of the pattern of so-called "bootstrap" sales to charities and took action thereon in the 1950 amendments *without* electing to change the tax consequences to sellers. See H.R. Rep. No. 2319, 81st Cong., 2d Sess. 36-40 (1950). Because of this Congressional action, as well as Congressional refusal in the Revenue Act of 1964 to do by statute what petitioner now seeks to have done by decision,[31] it is all the clearer that this Court should not torture the expression "sale or exchange" from its normal meaning to exclude a sale of the type here involved.

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[31] See pp. 52-54, 57 above.

2. The Transaction in Question Fits the Normal Meaning of the Word "Sale."

The term "sale" in common usage does not exclude transactions where the right to cash installments is subject to risk, or even where the price itself (unlike that of the present case) varies with the subsequent productivity of the asset transferred. This is shown by this Court's characterization as a "sale or exchange" of the transfers in *LeTulle v. Scofield, supra,* in which payment was almost completely at risk, and of the transaction in *Burnet v. Logan,* 283 U. S. 404, 412 (1931), in which the price depended on the productivity of the asset transferred. It is shown by the holding and language of this Court in *Helvering v. O'Donnell,* 303 U. S. 370 (1938), in which the taxpayer transferred his stock for a one-third net profits interest in certain oil and gas properties owned by his corporation. Unlike our case, there was no fixed price, and also unlike our case payment was *entirely* contingent upon net profits, with no reservation of a lien on the properties. Nevertheless, the Court, speaking by Mr. Chief Justice Hughes, called the transaction a "sale" of stock, and denied depletion to the seller.

Likewise, in *Anderson v. Helvering,* 310 U. S. 404 (1940), the taxpayer transferred certain oil property interests for a fixed price of $160,000, payable $50,000 in cash and $110,000 from proceeds of oil and gas produced. A lien was reserved (as in this case) on part of the property conveyed. As here, the parties clearly intended a sale. This Court held that:

> The deferred payments reserved . . . must be treated as payments received upon a sale to petitioners. . . . (310 U. S. at 413.)

In *Spring City Foundry Co. v. Commissioner,* 292 U. S. 182 (1934), the taxpayer sold goods on open account and unsecured notes, apparently with no down payment, for $39,983.27 to a purchaser which in the same year became bankrupt. Although the taxpayer eventually collected a far smaller proportion (27½%) of the debt in that case than did respondents in the present case, the Court characterized the transaction, despite its risky nature, as a "sale" (and indeed, before the advent of the novel theories set forth in petitioner's brief, it is doubtful that anybody would have considered that it might not be).

In non-tax cases, this Court has also defined the term "sale" with no indication that characterization as a sale depended upon the certainty of payment rather than the finality of disposition. In *Williamson v. Berry,* 49 U. S. (8 How.) 495 (1850), the Court stated, holding that a deed for a non-cash consideration was not a sale:

> . . . *sale* is a word of precise legal import, both at law and in equity. It means, at all times, a contract between parties, to give and to pass rights of property for money—which the buyer pays or promises to pay to the seller for the thing bought and sold. . . . (49 U. S. at 544).

In *Iowa v. McFarland,* 110 U. S. 471, 478 (1884), the Court said:

> A sale, in the ordinary sense of the word, is a transfer of property for a fixed price in money or its equivalent.[32]

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[32] See also *Waterman v. Mackenzie,* 138 U. S. 252 (1891).

The common understanding of what constitutes a sale was well expressed by Judge Madden in *Union Bank v. United States,* 285 F. 2d 126 (Ct. Cl. 1961), as follows:

> From the standpoint of the Goldenbergs, they were, before the 1951 transaction, the owners of valuable properties and a valuable going business. . . . After the 1951 transaction the Goldenbergs had no interest in these assets except a security interest, the power to take them back in case of default in payment for them. If they increased in value because of general prosperity or business success, or in dollar value because of inflation, the Goldenbergs would get no part of that important incident of ownership. . . . They did not and will not get the property back, and when the final payment is made by the Foundation in 1961, even their security interest in the property will be gone, and they will have no relation whatever to it.
>
> *We think it is logically and legally impossible for an owner to part with his property, for a consideration, without selling it.* The consideration which he gets for parting with his property is not income from the property, but is the price of his parting with the property. (285 F. 2d at 128.) (Emphasis added.)

If any source authoritatively indicates the common understanding of a "sale," it would be the Uniform Acts on the subject. Neither the Uniform Sales Act nor the Uniform Commercial Code, however, contain any hint of support for the idea that substantial risk of payment negates a sale. The Uniform Sales Act definition of a Sale (Section 1(2)) is as follows:

> A sale of goods is an agreement whereby the seller transfers the property in goods to the buyer for a consideration called the price.[33]

The Uniform Commercial Code, § 2-106(1) provides:

> A 'sale' consists in the passing of title from the seller to the buyer for a price (Section 2-401).

Either the Uniform Sales Act or the Uniform Commercial Code are in force today in most states of the Union. They state authoritatively the well understood meaning of the term "sale." It does not require certainty of payment or absence of risk. It does require the transfer of property in the goods or passage of title, *i.e.,* a complete disposition. Under the above definitions there can be no legitimate doubt that the transactions here in question constituted a sale.[34]

C. Characterization of the Present Transaction as Anything Other Than a Sale Creates Serious Distortions and Unnecessary Problems.

In the last analysis, this case involves a group of stockholders whose stock had greatly appreciated in value, and who irrevocably transferred the stock, and certain notes, receiving in exchange from the transferee cash in the amount of $936,131.85, and nothing else [R. p. 56]. If the transaction is characterized as a sale for tax purposes (and it would assuredly be so characterized for any other purposes), no particular problems arise and no uncalled-for tax benefits are conferred. The taxpayers have simply reclaimed their investment in the stock and notes and realized, recognized and paid tax on appreciation enjoyed by their stock over the years they owned it up to the time of final disposition. The provisions of the Code relating to sales and exchanges are designed for and nicely cover such a transaction.

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[33] See Williston, Sales, §§ 1, 2 (rev. ed. 1948).

[34] Even petitioner himself, on page 29 of his Petition, betrays his own understanding of the normal meaning of the term "sale," when he observes that respondents' stock was "sold to the Institute," neglecting the clothing of quotation marks with which he has elsewhere so assiduously disassociated himself from the term.

Were this Court to leave the beaten path provided by the statute and strike out through the uncharted and thorny thickets suggested by the petitioner, it would be immediately beset by a wide range of questions which petitioner has not answered. Nor will it do to shrug and leave such problems for the lower courts, as petitioner suggests (Pet. p. 23, n. 29). This Court recently refused to embark upon such an expedition in *Braunstein v. Commissioner*, 374 U. S. 65 (1963), and it is not difficult to demonstrate that far worse difficulties await here if the Court accepts petitioner's new and artificial distinction between final dispositions of capital assets for cash installments according to the seller's degree of risk.

In the first place, petitioner points to no satisfactory way within the charted statutory paths to give adequate recognition to the fact that the seller's basis is used up as payments are made. If the transaction is the "reservation of an income interest," the seller will one day have received his entire agreed price. What then? If the payments are treated as "dividends," there is no provision for cost recovery, and the seller is treated as receiving income which in fact he never received. Should each "dividend" be treated as in part a return of basis? Or should the taxpayer receive merely a capital loss on the last payment? The statute.

which never contemplated a category of complete cash dispositions which are not sales, is silent.

Secondly, the petitioner's novel proposed elevation of the degree of risk into the watershed between "sale" and "reserved income" treatment raises a host of new questions. How is a seller to know how risky his transaction can be and still constitute a sale? Will a subjective or objective standard of risk be employed? If the post-sale value of the business drops by an amount equal to the down payment, or if the buyer's other assets are lost, will subsequent installments become dividends? Conversely, in the low down payment case, will a post-sale *rise* in value sufficient to give the buyer a substantial equity convert subsequent installments into receipts of sale proceeds? Moreover, with this Court's decisions guiding the practical world of commerce all over the nation, it is scarcely satisfactory for this Court to wash its hands of responsibility for creating hitherto unheard-of ambiguities by stating, as petitioner glibly suggests, that whether a final cash disposition is too risky to be a sale is a "question of degree" (Br. p. 58). Any such doctrine would create the most serious uncertainties for a host of bona fide sales and exchanges characterized by retention of high risks.

A single example will illustrate this. In rapidly growing Southern California, hundreds of millions of dollars worth of land changes hands annually, as great areas of farmland become suburban subdivisions. The land is sold from the original owner to the developer who in turn sells to the ultimate land users. Land worth not over $1,000 per acre for grazing or raising barley increases in value as subdivision property to $25,000 per acre or more. The developer rarely makes a substantial down payment, and under California law he has no personal liability to pay the contract price.[35] Consequently, the landowner's receipt of his $25,000 per acre is almost completely dependent upon the developer's sales proceeds. The developers in turn sell to ultimate users—*e.g.*, homeowners. These sales are also non-recourse under the law but are also typically almost 100% financed, with the developer taking back second deeds of trust or installment sales contracts. Until now, nobody has doubted that all these transactions were "sales." Under petitioner's proposed criteria, these "sales" would apparently not be "sales" at all for tax purposes, because the sellers' payments would remain at risk. If adopted by this Court, these theories would cast grave doubt on the tax consequences of probably billions of dollars of transactions in this State alone.

Moreover, adoption of the petitioner's approach would produce a gaping disparity between the tax treatment of sales and exchanges. As we have seen, exchanges occur without reference to the retention or non-retention of business risk—and petitioner has not explained why sales should differ, thereby creating a tension between the two which has not heretofore existed, with unforeseeable consequences.

The term "sale" is central in the Code. The words "sale" and "sales" appear 635 times in Subtitle A alone (by computer search). The distortion of such a term by introducing the hitherto unheard-of concept of a maximum permissible risk of payment in otherwise arm's-length negotiated transactions would have literally unimaginable consequences in a multitude of other areas. Surely the parties themselves, at least in a bona fide negotiated transaction which makes economic sense, such as this one, are the best judges of what constitutes adequate security. The adoption of such a far-reaching and novel limitation on the concept of sale simply to gratify petitioner's desire (Pet. p. 30) for judicial legislation to discourage sales to charities would be using a sledge-hammer to kill the gnat.

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[35] In California there can be no deficiency judgment on a sale of real property where there is a lien on the property sold. Code of Civil Procedure § 580(b).

There is no way to predict the widespread repercussions in a host of other areas which would be created by a redefinition of the term "sales" to include only more-or-less risk-free transactions. A few examples are already apparent, however. If a residence is transferred on the usual low down payment, non-recourse basis, will it be a "sale" for purposes of Section 1034? Will a homeowner who is over 65 find that gain he had thought to be exempt under Section 121 will now be taxable because the transfer of his residence was on terms too risky to be a "sale"?[36] If stock in a foreign corporation is transferred for an inadequately secured agreed cash consideration, will this be a "sale or exchange" for purposes of Section 1246? If oil or gas property is transferred without adequate security or personal liability of the transferee, will Section 632 apply? If stock in a collapsible corporation is disposed of on such terms, will Section 341 be inapplicable because there was no "sale or exchange"?

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[36] In fact if petitioner's analysis is followed, the aged homeowner would apparently be taxed (and at ordinary rates) not only on his *gain* but on the entire sales proceeds as they come in! If this seems unfair to the homeowner, the same treatment is also unfair to respondents.

If Section 1245 property is so disposed of, will Section 1245(a)(1)(B)(i) (sales and exchanges) or Section 1245(a)(1)(B)(ii) (other dispositions) apply to determine Section 1245 gain? Will Section 483, applying to contracts for sale or exchange of property, apply to permit an interest deduction to the "buyer" if the seller did not make a "sale"? If a California landowner sells lots on the customary high-risk, low down payment basis, will he then be able to claim long-term capital gain treatment on a subsequent *cash* sale because he did not "hold his property for *sale* to customers in the ordinary course of his trade or business"? (Section 1221(1)). How would petitioner characterize a high-risk sale of non-income producing property?—*e.g.,* sale of a used car to a judgment-proof buyer. If it is not a "sale" because of the high risk, and is not a reservation of an income interest—because there is no income—what is it?

Enough has been said to indicate only the very threshold of the problems which would be created by leaving the statutory path and creating a hitherto unheard-of category of final dispositions of capital assets for a fixed cash consideration which are not "sales or exchanges." The problems are formidable. Only the sternest necessity should persuade this Court to embark on this new path—and not petitioner's mere desire to obtain a tax windfall from respondents in this case. If petitioner really believes that the term "sale" needs such redefinition, he should knock once more on the doors of the legislature.[87]

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[87] See pp. 52-54, 57, 62.

III.

THE OIL AND GAS CASES UPON WHICH PETITIONER RELIES IN FACT DEMONSTRATE THE OPPOSITE OF HIS CONTENTION.

Petitioner relies primarily upon a series of cases in the technical and specialized field of oil and gas taxation (Br. pp. 44-49). There are serious doubts as to the extent to which analogies from this line of authority can properly be applied in other fields, since tax concepts in the oil and gas field are informed by the exhaustible nature of oil and gas; by the provision for recovery of capital investment through the unique and all-important concept of percentage depletion; and by the concept that an oil and gas lease resembles "a manufacturing business carried on by the use of soil, to which the passing of title of the minerals is but an incident, rather than a sale of the land. . . ." *Burnet v. Harmel,* 287 U. S. 103, 107 (1932). Be that as it may, it is crystal-clear from the oil and gas cases that if they *are* accepted as persuasive authority for the present case, they only lend further support to the respondents' position that a sale occurred, rather than to the petitioner's view that there was a mere reservation of an economic interest.

Transactions in the oil and gas field cover a wide range, varying from a clear sale of property to a clear lease situation, with many puzzling gradations in between. In the case of an outright sale for a fixed cash consideration, the seller receives capital gain treatment and gets no further depletion allowance, while the buyer must report (as ordinary income) all the income subsequently derived from the purchased property, but receives the full depletion allowance against such income.

> It is settled that the same basic issue determines both to whom income derived from the production of oil and gas is taxable and to whom a deduction for depletion is allowable. That issue is, who has a capital investment in the oil and gas in place and what is the extent of his interest. . . .
>
> By an outright sale of his interest for cash, such an owner converts the form of his capital investment, severs his connection with the production of oil and gas and the income derived from production, and thus renders inapplicable to his situation the reasons for the depletion allowance. *Anderson v. Helvering,* 310 U. S. 404, 407-408 (1940).

In the case of a mineral lease in which the owner of an interest in mineral land contracts with an operator to develop the property, retaining part of the oil produced as a royalty with the remainder going to the operator, the tax consequences are equally clear. There is no "sale" but a mere withholding of the retained interest, and the operator agrees to pay no fixed amount of cash. Therefore the income from the owner's retained interest continues to be ordinary income to the owner, and is subject to the depletion allowance. *Burnet v. Harmel,* 287 U. S. 103 (1932); *Palmer v. Bender,* 287 U. S. 551 (1933). The same result follows if the owner retains a right to the gross cash proceeds from the retained oil, instead of a property interest in the oil in place,[38] and later decisions extend the principle to the retention of a participation in net profits.[39]

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[38] See *Helvering v. Twin Bell Oil Syndicate,* 293 U. S. 312 (1934); *Anderson v. Helvering,* 310 U. S. 404, 412 (1940).

A closer question is posed by the reservation of an "in-oil payment." Under this arrangement, the property owner reserves a given percentage of the minerals produced up to a stated sum, after which the property owner takes nothing further. This is closer to a true "sale," because there is a fixed maximum recovery. However, it is still treated as a retention or withholding, hence depletable, because in essence the owner has still merely carved out and reserved a portion of the income from his property, and has not transferred that portion. *Thomas v. Perkins*, 301 U. S. 655 (1937). As this Court stated in *Anderson v. Helvering, supra:*

> The holder of an oil payment right, as an original proposition, might be regarded as having no capital investment in the oil and gas in place. The value of the right, even though dependent upon the extent of the oil reserves, is fixed at the moment of creation and does not vary directly with the severance of the mineral from the soil. In this sense it resembles the right to cash payments more closely than the right to royalty payments. Yet it does depend upon the production of oil, ordinarily can be realized upon only over a period of years, and permits of a simple and convenient allocation between lessor and lessee of both the gross income derived from production and the allowance for depletion. Compare Burnet v. Harmel, 287 U. S. 103, 106, 107, 53 S. Ct. 74, 75, 77 L. Ed.

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[39] *Kirby Petroleum Co. v. Commissioner*, 326 U. S. 599 (1946); *Burton-Sutton Oil Co. v. Commissioner*, 328 U. S. 25 (1946).

> 199. Accordingly, this Court in Thomas v. Perkins decided that the provision in the lease for payments solely out of oil production should be regarded as a reservation from the granting clause of an amount of oil sufficient to make the agreed payments, and should be given the same tax consequences as a provision for oil royalties. (310 U. S. at pp. 410-411.)

Thomas v. Perkins, supra, marks the limit to which the doctrine of "reserved economic interest" can be stretched in the oil and gas field. As the Court in *Anderson v. Helvering* indicated, it could have gone either way, and the actual result was strongly influenced by the depletion allowance. Interestingly, Mr. Justice Stone, who wrote the Court's opinions in both *Burnet v. Harmel* and *Palmer v. Bender,* dissented (together with Mr. Justice Cardozo) in *Thomas v. Perkins.*

Petitioner relies principally on *Thomas v. Perkins* (Br. pp. 45-46). However, even if the principle of that case could be separated from the depletion allowance which gave it birth and could be elevated to a universally applicable measure of what constitutes a sale, other decisions of this Court make it clear that it would *not* apply to the present facts.

Under these decisions there are two requirements for the retention of a depletable economic interest (which as we have seen involves the "same basic issue" as the issue of whether a sale has occurred). (1) Acquisition by investment of "any interest in the oil in place," and (2) securing by legal relationship of "income derived from the extraction of the oil, to which he must look for a return of his capital." *Commissioner v. South-*

west Exploration Co., 350 U. S. 308, 314 (1956); *Palmer v. Bender,* 287 U. S. 551, 557 (1933). Neither requirement is met on the present facts, even if we follow petitioner's lead and consider the earning of business income to be analogous to extraction of oil.

(1) The retention of an interest in the "oil in place" is not met because respondents never had a direct interest in the business assets or income. They owned only stock in the corporation. In *Helvering v. O'Donnell,* 303 U. S. 307 (1938), this Court denied a depletion deduction to a stockholder who exchanged his stock in a corporation which owned oil leases for a share of the net income from production of the leased wells. The deduction was denied because, as a mere shareholder, he had no direct interest in the oil properties, and could retain none. He had therefore made a "sale" of his stock. Petitioner (Br. p. 47, n. 26) contends the case was later "all but overruled," apparently on the theory that it turned on the fact the royalty was based on "net income," and "net income" royalties have been subsequently held depletable. This misses the point of the opinion, which was stated by the Court in the following clear language:

> The question is whether respondent had an interest, that is, a capital investment, in the oil and gas in place. [Citations omitted.] As a mere owner of shares in the San Gabriel Company, respondent had no such interest. Treasury Regulations No. 69, art. 201. The ownership of the oil and gas properties was in the corporation. When the Midway Company acquired these properties from the San Gabriel Company and operated them, the Midway Company became the owner of the

> oil and gas produced. It was the owner of the gross proceeds or income upon which the statutory allowance for depletion was to be computed. (303 U. S. at 371.)

The fact that *O'Donnell* stands for the proposition that a stockholder cannot retain an income interest in his *corporation's* income-producing properties is confirmed by the cases of *Haynes v. United States,* 50 F. Supp. 238 (Ct. Cl. 1943) and *Tuttle v. United States,* 101 F. Supp. 532 (Ct. Cl. 1951), applying *O'Donnell* to permit capital gain treatment of proceeds of sales of stock in exchange not for *net profits* interests but ordinary oil royalties and (in *Tuttle*) an oil payment. It is significant that *Tuttle* was decided five years *after O'Donnell* was (supposedly) "all but overruled."[40]

Even petitioner's Regulations make clear that the distinction drawn in *O'Donnell* between selling stock and selling the underlying income-producing property remains in full effect and negates the "reserved income" theory as applied to a sale of stock for a price secured by income from the underlying business assets.

> Annual depletion deductions are allowed only to the owner of an economic interest in mineral deposits or standing timber. An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the extraction of the mineral or severance of the

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[40] See also *Warren v. United States,* 171 F. Supp. 846 (Ct. Cl.), cert. denied, 361 U. S. 916 (1959); *Glenn E. Alexander,* 34 T. C. 758 (1960).

> timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because through a contractual relation he possess a mere economic or pecuniary advantage derived from production. . . . *Further, depletion deductions with respect to an economic interest of a corporation are allowed to the corporation and not to its shareholders.* (Treas. Reg. §1.611-1(b)(1).) (Emphasis added).

Again, for purposes of Section 632,

> Shares of stock in a corporation owning oil or gas property do not constitute an interest in such property. (Treas. Reg. §1.632-1(a).)

(2) The requirement that the taxpayer must look *solely* to income from the reserved interest for return of his capital is not met because there was a retained lien on the assets of the former corporation, and because payments well in *excess* of buyer's after-tax income were guaranteed by the buyer if the income should prove subject to tax. The retained lien alone makes the case indistinguishable from *Anderson v. Helvering,* 310 U. S. 404 (1940). This case was virtually on all fours with *Thomas v. Perkins, supra,* with the one exception that in *Anderson* the seller received not only a cash down payment and an oil payment, but *also* a *lien* on the fee interests conveyed. This exception, however, made the difference between a *sale* and a reserved income interest. The Court said:

> The reservation of an interest in the fee, in addition to the interest in the oil production, however, materially affects the transaction. Oklahoma Com-

> pany is not dependent entirely upon the production of oil for the deferred payments; they may be derived from sales of the fee title to the land conveyed. . . . In the interests of a workable rule, Thomas v. Perkins must not be extended beyond the situation in which, as a matter of substance, without regard to formalities of conveyancing, the reserved payments are to be derived solely from the production of oil and gas. The deferred payments reserved by Oklahoma Company, accordingly, must be treated as payments received upon a sale to petitioners, not as income derived from the consumption of its capital investment in the reserves through severance of oil and gas. (310 U. S. at 412-413.)

Petitioner apparently seeks to distinguish *Anderson* on the grounds that there was a 31% down payment (Br. p. 46, n. 25). This will not do, because there was an almost equally large (28%) down payment in cash and notes in *Thomas v. Perkins,* which did *not* make that transaction a sale. Moreover, the opinion in *Anderson* relied entirely on the reservation of the lien, and not the down payment, and in *Commissioner v. Southwest Exploration Co., supra,* this Court, 350 U. S. at 314, did not even refer to the down payment in restating the holding of *Anderson.* Furthermore, neither the Commissioner nor the lower courts have interpreted the holding as so limited.[41]

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[41] See G. C. M. 22730, 1941-1 C. B. 214; Treas. Reg. § 1.611-1(b)(1); *Hugh Hodges Drilling Co.,* 43 B. T. A. 1045, 1069-70 (1941); *Refiners Production Co.,* 43 B. T. A. 481, 493-94 (1941); *Charles Burke,* 5 T. C. 1167 (1945), *Acq.,* 1946-1 C. B. 1; *cf. Scofield v. LaGloria Oil & Gas Co.,* 268 F. 2d 699 (5th Cir. 1959), *cert. denied,* 361 U. S. 933 (1960).

In the present case, retention of a lien upon business assets appraised at 82% of the total purchase price [R. p. 32] cannot be ignored. The economic significance of this lien is that in the actual case, despite drastic declines in value as the property became worthless from an income-producing standpoint, the lien still eventually accounted for $262,096.49 of respondent's total $936,131.85 proceeds of sale [R. p. 56]. If we are to apply the principles of the oil and gas cases, *Anderson,* as well as *O'Donnell,* only demonstrate further that the transaction was a sale.

CONCLUSION.

Petitioner requested a writ of certiorari in this case on the grounds that it was a tax case "of rare importance," (Pet. p. 7). He contends that it involves a purely tax-motivated transaction without economic significance (Pet. pp. 18, 33) and a grossly-excessive purchase price used to transmute ordinary income into capital gains (Pet. pp. 10, 33), and that it illustrates an area in which the lower courts had "unaccountably refused" to follow this Court's decisions (Pet. p. 16). On the above analysis, however, it is apparent that none of these representations are borne out by the facts, which negate the notion that the transaction was without economic significance. The realistic nature of the price demonstrates that respondents received no tax benefits to which they would not be entitled on any installment sale. The "unaccountable" unanimity of the lower Courts in holding such transactions to be sales turns out to be readily accounted for by all the prior opinions of this Court on facts such as this. In sum, the case turns out *on its facts* to present none of the issues which petitioner promised it would. It is in essence a routine and inevitable determination that a particular transaction on particular facts constituted a sale of stock, under all rational principles and previously decided cases. Petitioner has chosen to elevate this case to such unusual importance, not because it in fact presents any undecided questions of law, for it does not, and not because there is any disagreement in the lower courts, for there is none. Rather, it is because, disappointed by the limited extent to which Congress this year responded to his request for ordinary income treatment on sales where full payment depends on earnings, the Commissioner now hopes this Court will do for him what Congress refused.

In this situation, we respectfully urge this Court to do what it did in a similar situation in *Rudolph v. United States*, 370 U. S. 269 (1962). The case should be dismissed because certiorari was improvidently granted.

In the alternative, if the Court determines to decide the case, the opinion of the Court of Appeals for the Ninth Circuit should be affirmed.

Respectfully submitted,

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In the Supreme Court of the United States

OCTOBER TERM, 1964

No. 63

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CLAY B. BROWN AND DOROTHY E. BROWN, DONALD L. BROWN AND INGRID R. BROWN, CHARLES WILLIAM BOOTH AND NANCY H. BOOTH, DONALD LEE BROWN, PHILLIP F. BROWN, MARILYN BROWN

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

This brief is filed primarily in reply to the joint *amicus* brief filed on behalf of the University Hill Foundation and the taxpayers in four cases pending in the court below involving transactions between them and the University Hill Foundation similar to that involved in this case.

I

THE TRANSACTION MAKES NO MORE ECONOMIC SENSE WITH THE LIQUIDATION THAN WITHOUT IT

In our opening brief, in order to isolate the relevant part of the transaction for purposes of analysis, we assumed a simplified version of the transaction which omitted the liquidation and subsequent steps—to wit, a transfer of the stock to the Institute in exchange for notes under which the Institute's liability was limited to remitting 90% of any *dividends* received on the stock. The *amici* in effect concede that such a transaction would not be a "sale" for tax purposes:

> * * * the [transferor's] actions make no economic sense, would only occur for tax purposes and would necessarily involve a grossly excessive "purchase price" (any negotiations over which would be pure sham). Because the "purchase price" would grossly exceed fair value for the stock, the predominant nature of the * * * "sale" would be simply the retention of the "seller's" dividends on his stock for an extended term. A remainder interest would be gratuitously transferred to the "buyer" in the perhaps illusory hopes of obtaining more favored tax treatment on the retained dividends. * * * Were such a maneuver successful in producing capital gain, it might indeed involve * * * "extraordinary tax benefits" * * *. [pp. 9–10; see also 12–13]

> * * * [an] economically nonsensical proposition * * *, in which all possibility of gain on the upside would be sacrificed with no concomitant

> acceleration or downside cushion whatsoever. [p. 17]
>
> * * * where a "buyer" supplies no *quid pro quo* [as in the supposed case], he has nothing to bargain about, the rules of the market place will be inapplicable, and any resulting purported sale would merely be a gratuitous transfer of a remainder interest in stock in hopes of reducing the taxes on subsequent retained earnings. * * * [pp. 18–19]
>
> * * * the "sales price" will be paid only at the same rate as the income the "seller" would otherwise have earned, and the element of risk becomes infinite, because there is no cushioning whatsoever of the seller's downside risks to compensate for the sacrifice of possible appreciation on the upside. Therefore, there is no economic justification for less than an infinite amount of compensation for risk and futurity, and the transaction would occur at all only for tax purposes. * * * [p. 21, n. 9]

Having conceded our major premise—that such an economically meaningless transaction is not a sale[1]—the *amici* then devote over 30 pages of their brief (Br. 9–41) to a claim that the simplified version of the transaction is a "straw man" and that in the actual transaction, unlike the simplified version, the Institute *did* furnish a "substantial and meaningful *economic quid pro quo*" (Br. 13) and the transaction thus "made good economic sense to the sellers *without reference to their income taxes* and without an unreasonably high price" (Br. 10, emphasis added). The primary dispute between the *amici* and the government, then, is simply whether the actual transaction was or was not as "economically meaningless" as the simplified version analyzed in our main brief. We will show that it was.

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[1] *Amici* never quite expressly concede the ultimate conclusion, but the quoted portions of their brief hardly leave the matter in doubt.

In the simplified transaction, *A* transfers stock to *B* on *B's* promise to remit the dividends up to a stated amount (the purported "price"). The *amici* agree that such a transaction (and any "bargaining" over it) is economically meaningless because it gives *A* nothing that he did not already have. The actual transaction is wholly different, say the *amici*, because in it the Institute agreed, not merely to remit dividends, but to *liquidate* the corporation and to remit 90% of the earnings from the *assets*, an amount substantially greater (because of the elimination of the corporate income tax) than the respondents could have received as dividends had they kept the stock. The Institute's ability to "double" the earnings and thereby make accelerated payments to respondents gave the respondents a "cushion" to assure ultimate receipt of the purchase price and, by the same token, gave the Institute real bargaining power.

If the Institute did indeed have the magical power to make something of nothing, we would be hard pressed for a reply, for we basically agree with *amici* that a transferee's ability to increase the productivity of an asset (*e.g.*, by contributing services or managerial skills) may be enough in itself to make a transaction a "sale" (see Pet. Br. 62–65). Like most demonstrations of magic, however, the argument turns out to be sleight-of-hand. The *amici* compare (1) what the Institute could realize (and remit to respondents) from liquidating the corporation and leasing its assets with (2) what the respondents could realize by not liquidating the corporation and receiving dividends. The only meaningful comparison, of course—if the purpose be to identify what the Institute contributed to the transaction—is with (3) what respondents could realize by themselves liquidating the corporation and leasing its assets. The "sale" and the liquidation were separable parts of the transaction, and if the liquidation is to be taken into account in appraising the results of the "sale," it must also be taken into account in appraising what the results would have been without the "sale." And if that comparison is made, it will be seen that the actual transaction is made up of the same straw as is the simplified version analyzed in our opening brief.

If respondents had themselves liquidated the corporation and "leased" the assets to Fortuna on the same terms as did the Institute, they would have received 100% of the amounts paid as "rent" by Fortuna. In the actual transaction—in which the stock was first "sold" to the Institute and the corporation was then liquidated—respondents were entitled to receive 90% of the amounts paid by Fortuna. The "substantial and meaningful *economic quid pro quo*" brought by the Institute to the transaction, then, was its agreement to remit to respondents 10% *less* than the amounts they would have received by engaging in the same transaction without its participation! Nor did the Institute's purported[2] "guarantee"—that it would remit 90% of the rents whether or not it was required to pay a tax on them—add anything, for all that it "guaranteed" was an economic loss.[3]

In economic terms, therefore, the Institute's participation in the actual transaction, just as in the simplified version, could only result in a loss to the respondents; it was an "economically nonsensical proposition * * *, in which all possibility of gain on the upside [was] sacrificed with no concomitant acceleration or downside cushion whatsoever" (Am. Br. 17). Rather than making "good economic sense to the sellers *without reference to their income taxes*" (Am. Br. 10, emphasis added), it was only through the effect of the transaction on their personal taxes that respondents could hope to gain from the transaction. Without the Institute's participation, respondents could have had 100% of the "rents" paid by Fortuna and retained full ownership of the assets; with it, they got only 90% and in addition surrendered the ultimate ownership of the assets; their only hope of gain was that, with the "rents" being channeled through the Institute and then being remitted to them as payments of a "purchase price", their lessened receipts would be taxable to them only as capital gains rather than as ordinary income, producing a *tax-saving* more than sufficient to compensate respondents for their substantial and undeniable *economic loss.*[4] There is no other explanation for the transaction and it, like the simplified version examined in our opening brief, was "economically nonsensical" and "would only occur for tax purposes" (Am. Br. 17, 9). The actual transaction was thus not a "sale" for precisely the same reasons that the *amici* concede the simplified version would not be.

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[2] The Tax Court found that respondents never "sought to find out about the Institute's financial condition at the time of the transaction" and that its resources in fact fluctuated from zero to $200,000 or $300,000, depending on the need for funds for cancer research (R. 47). Some of the other transactions in which the "guarantee" was allegedly of the essence involved "feeder" corporations capitalized at $1,000 (see Am. Br. 35).

[3] Had respondents themselves liquidated the corporation and leased the assets, not only would the amounts received by them have been greater (100% rather than 90% of the "rents") but they would have been received directly from Fortuna without being channeled through an intervening entity, thus eliminating entirely any risk of their being taxed first to someone else.

II

THE TREATMENT OF THE TRANSACTION DOES NOT DEPEND UPON FINDINGS OF VALUE

The *amici* state our view as being "that a grossly-excessive purchase price is * * * the infallible touchstone by which the unreal, purely tax-motivated transaction can be spotted" and conclude that: "Thus in petitioner's view, the entire case hangs on the reasonableness of the purchase price" (Br. 26–27). The *amici* have misunderstood our position and put the cart before the horse. Our case begins and ends with the terms of the agreement itself. Since on the face of the agreement it is apparent that the Institute gave nothing in exchange for the property and made no commitment that could in any way lessen the risks borne by respondents, there was no sale. There being no "cushion" of any sort to assure payment, respondents' receipts were entirely dependent upon the income thereafter produced by the property, and their right to those receipts was neither more nor less than a retained right *to* that income. And whether the amount of income reserved by a transferor happens to be just equal to the value of the property transferred or is greatly in excess of it is ultimately irrelevant: in either case, what is received is income and must be taxed as such.

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[4] They equally hoped, of course, to avoid an immediate capital gains tax on the liquidation of the corporation, in which endeavor they have thus far been successful (see pp. 20–25, *infra;* Pet. Br. 15).

The irrelevance of findings of "value," moreover, cuts both ways: a "sale" is no less a sale because the price is excessive, and a right to income from property is no less a right to income because it is limited to an amount that happens to be equal to the value of the property. If *A* transfers stock to *B* in exchange for *B*'s personal note for $1500, a finding that the stock was actually worth only $1000 would establish only that *B* was gullible or badly informed, not that the transaction was not a "sale"; the note, backed by the personal liability of the solvent purchaser, gives *A* a right to payment independent of the income thereafter produced by the property and the burdens and benefits of ownership are shifted to *B*. If, on the other hand, *A* transferred the same stock to his son on his son's promise to remit the dividends up to a stated amount, *A*'s right to receive the dividends would still be but a right to income whether the amount was $500, $1000, or $1500. It would be a right to income because, quite simply, *A* would have a right to nothing else.[5] The character of the transaction turns, in short, not upon how much the transferor may eventually receive from his interest, but upon the nature of the interest itself—whether it is a right wholly dependent upon, and thus a right to, future income or is, instead, a right to payment independent (at least to a significant degree) of the income produced.

Since questions of value are ultimately irrelevant, we need make only two brief comments on *amici's* extended argument about the findings in this and other cases (Br. 26–41).

First, the effort by *amici* to prove that the "buyer" in such transactions furnishes an "economic *quid pro quo*" by showing that several courts have found the "prices" not to be grossly excessive is absurd.[6] The terms of the transactions are established by undisputed documentary evidence showing precisely what each party contributes to the transaction (the "buyer," nothing) and what each gets out of it (the "seller," nothing, unless it be a hoped-for tax advantage); it is hardly necessary to reason backwards from findings of value to discover what those terms were. Inasmuch as *amici* agreed with us that only an "irrational seller" (Br. 40) would enter into such a transaction—*i.e.,* one as "economically meaningless" as the documents show these to be—at the same price at which he could otherwise sell the stock, what the numerous findings of "fair" or "reasonable" or "not grossly excessive" prices[7] prove is only that: (1) in view of the universally recognized difficulty of valuing closely-held businesses, there is inevitably a wide range of valuations that can be defended as abstractly "reasonable"; (2) that the "sellers" in such transactions were accurate in their estimate of how high the price could be set without being so flagrantly excessive as to jeopardize the desired tax treatment; (3) that *amici's* confidence in the valuation process to separate true "sales" from "economically meaningless" transactions (Br. 41) is misplaced.

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[5] The only time the value of the stock would even arguably become relevant would be if (a) the amount of the dividends to be remitted was significantly *less* than the value of the stock and (b) *A* also had a right to "foreclose" on the stock if the amount was not received by a stated time (see Pet. Br. 36, 56). In this case, although respondents did have a foreclosure right, no claim is or could be made that the amount to be remitted was *less* than the value of the stock. The most that is claimed is that it was not "much" more than the value.

[6] Far more significant in showing the true character of the transactions are the few instances, involving equally arm's length transactions (indeed, with the same charity as in most of the other cases), in which the sellers failed to heed the advice of the tax commentators and set the "price" so high that, even with the wide latitude that exists in assigning a "reasonable" value to a closely-held business, the price was still found

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to be grossly excessive, a result that could not occur if the charity had real economic bargaining power. See *Union Bank* v. *United States*, 285 F. 2d 126 (Ct. Cl.); *Brekke* v. *Commissioner*, 40 T.C. 789.

[7] We note that *on the terms of payment agreed on* the only truly "fair" and "reasonable" price would be an infinite one; in every case, the "price," far from being "grossly excessive," is in fact grossly inadequate.

Second, the Tax Court in this case did not find, as *amici* imply, that the amount of the rents to be remitted to respondent was no greater than the amount for which they could have sold the stock on normal commercial terms (*i.e.,* with the buyer making a significant commitment and assuming at least the primary risks)—which, in turn, is the only meaningful definition of "fair market value." Addressing itself specifically to that question, the court expressly acknowledged that "It may be" that respondents could not have sold the stock "at as favorable a price" in any other kind of transaction, but held that a taxpayer has a right "to increase the amount received" by his choice of transactions and that the fact that the charity in such transactions "is willing to pay a somewhat higher price than someone else might pay" did not prevent the transaction from being a "sale" (R. 62).[8] It was only to show—in response to an entirely different argument[9]—that the Institute acted at arm's length with a real (and reasonable) expectation that the rents would be sufficient to complete the payments, and that it would therefore ultimately receive the properties (see R. 36), that the court later observed that the "price" was "the result of real negotiating" and "was within a reasonable range in light of the earnings history of the corporation and the adjusted net worth of the corporate assets" (R. 64). Rather than being inconsistent, what the latter comment shows is that there is indeed a wide "range" between what a closely-held business can actually be sold for on normal commercial terms and what can be defended as being "within a reasonable range in the light of * * * [etc.]"—the very fact that has made it possible for the nature of these transactions to be so successfully cloaked. Finally, if "market value" were relevant (which it is not) and if the Tax Court had found the amounts to be remitted to be no greater than the market value (which it did not), the findings would have to be reversed for internal inconsistency, however sufficient the formal evidence supporting each might be: as *amici* agree, only fools or benefactors give away something for nothing, and the Tax Court's findings that respondents were neither precludes a finding that they did.

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[8] The court of appeals similarly acknowledged that the amount to be remitted was "probably greater" than the market value of the stock (*i.e.,* the price obtainable on normal terms) (R. 295).

[9] *I.e.,* that the transaction was a "sham" in the sense that the pay-out was never expected to be completed and there was a "tacit understanding" that respondents could at any time precipitate a default and recover the properties (see R. 59, 62–63).

III

IF THE LIQUIDATION WAS A "REALIZING EVENT," RESPONDENTS SHOULD HAVE PAID A CAPITAL-GAINS TAX IN THE YEAR OF THE LIQUIDATION, BUT THEIR SUBSEQUENT RECEIPTS WOULD STILL BE TAXABLE AS ORDINARY INCOME

To side-step the argument made in our opening brief, the *amici* would make everything in this case turn on the liquidation. They do not deny that if a transferor retains by contract a right to be paid the income produced by the very property transferred (as in our "simplified version" of the transaction), the income thereafter remitted to him is ordinary income. The result is wholly different, however, say the *amici*, if the interest the transferor has after the transaction is a right to the income, not from the very same property, but from some substituted property. For in that event there is a "realizing event" (the conversion of an interest in one property into an interest in other property), and the existence of a "realizing event" somehow means—*amici* never say how—that any income thereafter received is taxable only as capital gain. In this case, the liquidation is said to have resulted in such a "realizing event": without the liquidation, respondents would have had a right to the income from the *stock;* with the liquidation, they had instead a right to the income from the *assets;* since the [redacted] "exchange" of stock for a right to income from assets is a "realizing event", the income from the assets thereafter received is, by some form of alchemy, converted into capital gains. As we will show, *amici's* argument about the tax effect of the liquidation is fully as baseless as their argument about its economic effect (Point I, *supra*).

1. We have no reason to object to treating the liquidation as a "realizing event" and are quite willing to assume, for purposes of argument, that it was. For what is wrong with *amici's* argument is not the proposition they argue at such length (that the liquidation was a realizing event) but the proposition they assume *sub silentio:* that, if a right to income is received in a realizing transaction (rather than being merely retained in a non-realizing transaction), the

income thereafter received pursuant to that right is taxable only as capital gain. So novel and revolutionary is the proposition that it requires but a few examples to demonstrate its fallacy.

Suppose that *A* wishes to dispose of a house which he bought for $20,000 but which has appreciated in value to $30,000. If he sold the house for $30,000, he would have a capital gain of $10,000. Instead of selling it, however, he transfers it to *B* in exchange for an assignment of one-half of *B*'s life estate in a trust, an interest which at the time is worth $30,000. Thereafter during the course of *B*'s life, *A* receives income distributions from the trust totaling $100,000. The exchange of the house for the trust interest was undeniably a "realizing event." Does it follow that the entire $100,000 received from the trust is gain from the "sale" of the house, taxable only as capital gain? The answer, of course, is no.

As *amici* agree, the purpose of the capital-gains provisions was to lessen the tax burden on the realization in a single year of the "accumulated increments of value over the prior years" (Br. 45), the "previously accrued but hitherto unrealized gains of prior years" (Br. 46), or the "appreciation enjoyed by [the asset] over the years [the taxpayer] owned it up to the time of final disposition" (Br. 67). See also Pet. Br. 59–61. They were not intended to shield from the regular tax the future income from the interest received in an exchange. And the only way that the accrued gains can be separated from the future income is by *valuing* the interest received in the exchange and using its value as the dividing line: the excess of the value of the interest received over the basis of the asset exchanged is taxed as capital gain; the taxed value becomes the basis of the interest received; and the income thereafter produced by that interest is taxed according to its own nature, with whatever allowances for basis recovery are appropriate (*e.g.*, depreciation or amortization). In effect, the transferor is treated as though he had sold the asset for an equivalent amount of money and then purchased the acquired interest with the proceeds.

In the case supposed, the "amount realized" from the "sale or exchange" of the house would be $30,000, the *value* of the trust interest, producing a capital gain on the disposition of the house of $10,000. *A* would then have a basis of $30,000 in the trust interest which, since that interest is a wasting asset, could be amortized against the $100,000 of income thereafter received, leaving net ordinary income of $70,000. In short, *A*'s total gain of $80,000 over the entire period would be divided between $10,000 of capital gain and $70,000 of ordinary income, the obviously correct result.

The point—so rudimentary that it would not require stating but for *amici's* obscuring it—is that, if in a "realizing event" a transferor receives a right to income in exchange for a capital asset, the only "amount realized" "from" the exchange itself (and hence the only amount taxable as capital gain) is the *value* of the right to income; the income thereafter produced by that right remains fully taxable as ordinary income. Capital gain is "gain from the sale or exchange of a capital asset" (§ 1222(3)); the "gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis" (§ 1001(a)); and the "amount realized from the sale or other disposition of property shall be the sum of any money received plus *the fair market value of the property (other than money) received*" (§ 1001(b)). Since a right to future income is "property (other than money)", it is only the "fair market value" of the right received that enters into the computation of capital gain.

Nor is it any more relevant to the treatment of a "received" interest than it is to the treatment of a "retained" interest whether, in property-law concepts, the right to the income is viewed as a property interest in the underlying asset or as merely a "contract right" to be paid the income from it (see Pet. Br. 41). For tax purposes (and, indeed, for State-law purposes), a "contract right" is as much "property" as is an interest in tangibles, and whichever form the "property" received in the exchange is in, it is only its "fair market value" that constitutes the "amount realized" from the exchange. Thus, in the above example, it would make no difference if, instead of "assigning" a half-interest in his life estate, *B* simply "covenanted" to remit to *A* one-half of all the distributions he received from the trust and pledged the trust interest only as "security" for the promise. Were such a mere change of form successful in converting the entire $100,000 thereafter received by *A* from the trust income into "capital" receipts from the "sale" of his $30,000 house, it is not hard to see that the distinction between ordinary income and capital gain would be short-lived.

To take another example involving a liquidation as the "realizing event," suppose that a corporation owned equally by *A* and *B* constructs a building on leased land and then leases the building to a department store for the full remaining term of the ground lease. When the lease still has 20 years to run and when the value of the leasehold is just equal to the stockholders' basis in their stock (so no capital-gains tax need be paid), *A* and *B* decide to liquidate the corporation in order to eliminate the corporation income tax and to be able to take depreciation on the leasehold themselves. If they did no more than that, *A* would receive on liquidation a half interest in the leasehold with a basis just equal to his basis in the stock (there being no gain); he would be entitled to amortize the basis against the rents thereafter received, and the balance would be taxable as ordinary income.

Instead of doing that, however, *A* (perhaps having read *amici's* brief) transfers his stock to *B* on *B's* "personal covenant" to liquidate the corporation and thereafter to remit to *A* one-half of the rents received for the life of the leasehold, the promise being "secured" by a mortgage on the building and an assignment of the rents.[10] Since the liquidation results in a conversion of *A*'s stock interest into something "different," there is no doubt a "realizing event."[10] Does it follow that *A* is entitled to report all of the rents remitted to him for the next 20 years (in excess of his basis for the stock) only as capital gain—*i.e.*, as "amounts realized" from the "sale" of his stock? Once again, the answer obviously is no. The "property" received in exchange for the stock was, not the rents themselves, but the contract right to receive them, and it is only the "fair market value" of that right that enters into the computation of capital gain or loss. That right being worth no more than *A*'s basis for the stock, there is no capital gain at all. The rents thereafter remitted to *A* are but the return on his still unrecovered investment and are fully taxable as ordinary income (subject only to amortization deductions for his basis in the wasting asset).[11]

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[10] The same thing could be accomplished, of course, by *B* giving *A* a "promissory note" in an amount equal to one-half of the total rents to be paid over the remaining leasehold term but limiting his personal liability to an obligation to remit one-half of the rents actually received.

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[11] In the case supposed, there would be no doubt of *A*'s right to amortize his full basis against the rents received, since the underlying property—the leasehold—was itself a wasting asset (see § 167). In this case, however, there is a serious question whether respondents were entitled to amortize their full basis. A term interest in property is itself, of course, normally a wasting asset even though the underlying property (*e.g.*, land or stock) is not. But when the limitation on the term is created by a *gift* of a remainder interest, no amortization is permissible. If, for example, a father gives his son a remainder interest in stock, reserving the right to the income for life, he cannot allocate a part of his basis to the reserved life estate and then depreciate or amortize that part of the basis on the ground that the life estate is a wasting interest; rather, the donor's entire basis "shifts" to the donee as the remainder matures, so that the son will end up with his father's full basis. The same thing is true of a life tenant and remainderman receiving their interests from a common donor. See Income Tax Regs.

In short, the *amici's* entire argument is based on the fallacious premise that, if a contract right to receive future payments of money is received in a "realizing event," the future payments when received are taxable only as capital gain notwithstanding that the right to receive them was itself a right *to income.* To the contrary, as we have shown, if the right held by the transferor after the transfer is a right to income, the income when received must be taxed as such and it matters not at all, for that purpose, whether the right was one "retained" in a non-realizing transaction or one "received" in a realizing transaction. As shown in our opening brief, in turn, respondents' right to receive 90% of the income from the assets up to $1,300,000 (plus a right to recover the property if that amount was not received by a stated time), having been in no way underwritten by the Institute and being wholly dependent on the future income, was neither more nor less than a right to the income from the property. That being so, the income thereafter remitted to them was taxable as ordinary income, whether or not the original transaction was a "realizing event." The only significance of the question whether there was a taxable event in 1953, as we will

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(1954 Code) §§ 1.1014-5, 1.1015-1(b). In this case, since the limitation of the respondents' interest to a temporal interest in the business was the result simply of a gift of the residual interest to the Institute, it would seem that they were *not* entitled to amortize their basis except to the extent that it was attributable to depreciable underlying assets. Since the Commissioner did in fact allow respondents to offset their full basis in the stock against the payments, however, the question is not presented here.

now show, is whether respondents should not have paid a capital-gains tax in 1953 *in addition* to an ordinary-income tax on the remitted rents.

2. If the respondents had themselves liquidated the corporation in 1953 and then leased its assets to Fortuna, they would admittedly have had to pay (1) a capital-gains tax in 1953 measured by the excess of the value of the assets over their basis for the stock (§ 331) *plus* (2) an ordinary-income tax on the rents thereafter received from Fortuna (less depreciation on any depreciable assets based on the value at which they were taxed on the liquidation).[12] The same result would follow if respondents had themselves liquidated the corporation and then transferred the *assets* to the Institute on terms otherwise the same as those of the actual transaction.[13]. The question is whether the fact that the stock, in form at least, was transferred to the Institute *before* the liquidation "insulated" respondents from taxability on the liquidation and, if

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[12] We are assuming, for purposes of this discussion, that the liquidation of the corporation and the purported "lease" of its assets to Fortuna did not constitute a "reorganization" and, further, that the "lease" is to be treated as a true lease rather than as an "equity" or "stock" interest in Fortuna. Should the issue become important on remand of the case—it is not relevant to the issue before this Court—we would argue to the contrary (see Pet. Br. 73–75).

[13] In that event, we take it that even *amici* would agree that the transfer to the Institute would not be a "sale." With the liquidation already having taken place, it could hardly be the "*quid pro quo*" furnished by the Institute (see Point I, *supra*), and since the "rents" would come from the very property transferred (*i.e.*, assets, not stock), the right to them would be but a "retained" interest in the property, not a different interest received in "exchange" for it.

not, how their gain should be measured. There are three possibilities to be noted.

a. Under the so-called "step transaction" doctrine, as *amici* note (Br. 59–60), the ordering of the several steps of an integrated transaction is not necessarily determinative of the tax consequences, and the tax treatment is to be determined according to the true nature of the transaction considered as a whole.[14] Apparently not appreciating the implications of the argument, *amici* cite Rev. Rul. 60–370, 1960–2 Cum. Bull. 203,[15] as a proper application of that principle to a transaction like this one and thus as establishing that the liquidation here was a taxable event to respondents (Br. 56). In that ruling, appreciated securities were conveyed to a university subject to a requirement that the university sell the securities, reinvest the proceeds in tax-exempt bonds, and pay the income from the bonds to the transferor for his life. The ruling held that, since the university was required to convert the appreciated securities into other property, "in substance, the transferor did not give the trustee appreciated property to hold in trust, but, rather, gave the trustee the proceeds of the sale or exchange of the property which the trustee was required to consummate" (p. 205), and, accordingly, that the transferor was taxable on the gain realized on the sale of the securities.

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[14] *Gregory* v. *Helvering*, 293 U.S. 465, 469–470; *Minnesota Tea Co.* v. *Helvering*, 302 U.S. 609, 613; *Bazley* v. *Commissioner*, 331 U.S. 737, 741–743; *Commissioner* v. *Court Holding Co.*, 324 U.S. 331, 334; *Georgia-Pacific Corp.* v. *United States*, 264 F. 2d 161, 162–163 (C.A. 5); *United States* v. *General Geophysical Co.*, 296 F. 2d 86 (C.A. 5), certiorari denied, 369 U.S. 849.

[15] But cf. Rev. Rul. 55–275, 1955–1 Cum. Bull. 295.

Amici make a strong case that there is "no tenable distinction" between the transaction involved in the ruling and that involved in this case (Br. 56). We are inclined to agree, and if the ruling is sound, what it means is that, since the terms of the agreement specifically required the Institute immediately to liquidate the corporation—the several steps were, indeed, all consummated on the same day—respondents should be treated as having themselves liquidated the corporation and as having in substance transferred only the assets (not the stock) to the Institute. What *amici* unaccountably fail to note, however, is what the tax consequences of that treatment would be: respondents would have to pay a capital-gains tax in 1953 measured by the full value of the corporate assets and *in addition* pay an ordinary-income tax on all the "rents" thereafter received from their "retained" interest in the assets[16]—which was, in fact, precisely the treatment accorded the transaction in Rev. Rul. 60-370, *supra*. It is small wonder that respondents do not share *amici's* enthusiasm for treating the liquidation as a "realizing event" but rather expressly disavow (as we predicted they would, see Pet. Br. 75) any "contention that liquidation has independent capital gain significance" (Resp. Br. 36-37).

b. A second alternative—which gives partial effect to the form of the transaction but still produces a taxable event—would be to treat the gift to the Institute of a residual interest in the *stock* as an event of independent significance taking place before the liquidation and then treat the liquidation as resulting in a taxable conversion of the respondents' retained income interest in the stock into an income interest in the assets.[17] The liquidation would be treated as resulting in a taxable "sale or exchange" to the respondents, but the "amount realized" from it would be, not the full value of the assets, but only the value of the interest in them which respondents ended up with (*i.e.,* the right to 90% of the income from them up to $1,300,000 plus contingent rights of recovery). That value would be equal basically to 90% of the value of the assets, with some appropriate deduction for the conditional residual interest given to the Institute. Apart from that slight difference in the measure of the gain, however, the tax consequences would be substantially the same as under the first alternative: respondents would be taxable *both* on the original transaction (capital gain, measured by the value of the *right* to income received in the exchange) and on the rents thereafter received (ordinary income, lessened somewhat by the stepped-up basis for depreciation).[18]

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[16] As noted above, they would of course have a basis for depreciation of the depreciable assets increased to the value at which they were taxed on the liquidation.

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[17] We note the possibility only for the sake of completeness. In fact, it seems to us to have little to commend it and to produce an anomalous difference in result between economically identical transactions and give to the form of the transaction a significance inconsistent with the step-transaction doctrine. In fact, as Rev. Rul. 60-370 recognized in identical circumstances, the Institute never received a beneficial interest in the stock itself since it was required under the very terms of the grant immediately to liquidate the corporation; in substance, all it ever received was an interest in the assets themselves—a current right to 10% of the income from them plus the right to full beneficial ownership upon the expiration of the respondents' retained interest.

c. By giving full effect to the form of the transaction, it is possible to argue, as a final possibility, that the liquidation was not taxable to respondents at all. They had previously transferred their stock to the Institute, and in form it was the Institute, not respondents, who liquidated the corporation. To the Institute, the liquidation was a tax-free transaction, not only because it was an exempt charity, but because it was itself a corporation and the Code provides expressly for non-recognition of gain or loss on a parent's liquidation of a subsidiary (§ 332). Since the transformation of the stock into assets was a tax-free transaction, the transformation of respondents' retained interest in the stock into an interest in the assets should likewise be treated as a nontaxable transaction; respondents' interest would thus still be a "retained" rather than an "acquired" interest, albeit in property held in a new form of ownership as a result of a tax-free transaction. Were that the proper treatment, respondents would not have been subject to a capital-gains tax on the original transaction, but they would, of course, be fully taxable on the rents thereafter received by them under their "retained" right to income.

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[18] Were the 1953 gain to be measured by the value of the *limited* income right retained (or received) by respondents, rather than by the full value of the assets, it might on the surface seem to enhance their right to write off the full amount of their basis (the taxed value) against the subsequent receipts, rather than being allowed to take depreciation only on the depreciable assets. Regardless of which way the transaction is taxed, however, the limitation of respondents' rights to a temporal interest was the result solely of a *gift* of the residual interest to the Institute, and, as noted previously (note 11, *supra*), a taxpayer cannot convert a nonwasting asset into a depreciable one by making a gift of a remainder interest.

We have shown that under each of the possible ways of treating the liquidation, the subsequent proceeds of respondents' right to receive 90% of the income from the assets would still be taxable as ordinary income. Whether, as a result of the liquidation, there was (as *amici* contend) a "realizing event" in 1953 is a question relevant only to (1) whether respondents should *also* have paid a capital-gains tax in 1953 and (2) whether, as a consequence, they are entitled to a stepped-up basis for depreciation of the depreciable assets. Since the Commissioner did not assert a tax on the liquidation, it is too late now for the government to raise the question. Respondents, on the other hand, could now claim a stepped-up basis as a result of the liquidation only by exposing themselves to a further deficiency for 1953 (see §§ 1311–1314), which they are understandably unwilling to do (see Resp. Br. 36–37). And the *amici* obviously have no standing themselves to raise the question. Accordingly, the question is not before the Court and need not be decided.

3. While some lower court decisions have made *amici's* mistake of assuming without discussion that, so long as there is a "realizing event," the proceeds of any "contract right" to future payments are necessarily taxable only as capital gain notwithstanding that the right is itself a right to income, none of the decisions of this Court cited by *amici* in any way

support the proposition. In *LeTulle* v. *Scofield,* 308 U.S. 415 (Am. Br. 49, 63), which is irrelevant in any event,[19] only the *value* of the interest received was treated as the "amount realized" in the exchange. *Helvering* v. *O'Donnell,* 303 U.S. 370 (Am. Br. 59, 63, 76–77), involved only a depletion question and was decided on concepts peculiar to that question—which, moreover, have since been rejected even for depletion purposes.[20] *Arrowsmith* v. *Commissioner,*

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[19] *LeTulle* held only that the transfer of the assets of one corporation to another in exchange for cash and bonds was not a "reorganization" since the bonds did not satisfy the "continuity of interest" requirement. No claim was made that the bonds actually represented an "equity" rather than a "debt" interest, and in any event it may well be that "continuity of interest" requires an interest that is "equity" in form as well as in fact. Nor were the facts at all similar. The transferee not only made a substantial payment in cash but, in contrast to the Institute's purely passive role, was to operate the properties itself. As to the adequacy of its capitalization, all that appears is the statement of the court of appeals that the transferee "apparently had little capital, and found difficulty in" paying all cash for the property (103 F. 2d 20, 21), which is far removed from a finding that the transferee made no substantial investment in the enterprise (either of money or services) and thus did not relieve the transferor even of the primary risks.

[20] *Amici* to the contrary notwithstanding, all *O'Donnell* held was (1) that "ownership" of the "oil and gas in place" was prerequisite to depletion; and (2) that a "personal covenant" to pay a share of the "net profits" derived from production did not create such an interest. The distinction between a "personal covenant" and "an interest in the properties themselves" drawn in that case (303 U.S. at 372) has not survived even for depletion purposes (see Pet. Br. 47, n. 26). In any event, since a "personal covenant" is *itself* "property" within the meaning of the capital gains provisions (§ 1001(b)), whether it results in an "ownership" interest in some underlying prop-

344 U.S. 6, involved nothing resembling a right to income from property and for what it is cited (Am. Br. 59) is not apparent.[21] That leaves for discussion only *Burnet* v. *Logan,* 283 U.S. 404 (Am. Br. 45, 59, 63), a case so frequently mis-cited that a full analysis seems appropriate.

Burnet v. *Logan* involved a transaction occurring in 1916, well before special treatment was first accorded capital gains (in 1921). The case was concerned, therefore, not at all with the character of the gain as ordinary income or capital gain, but only with the proper time of accounting for certain receipts by a cash-basis taxpayer. The stockholders of a steel company which owned rights to 12% of the production of an iron-ore mine transferred all their stock to another steel company in exchange for $2,200,000 plus the company's agreement to pay them 60 cents for each ton of ore it received under the acquired rights. The question was whether the stockholders had to account immediately not only for the cash payments but also for the value of their contract right to receive the per-ton payments. The Court held that since the promised payments were "wholly contingent upon facts and circumstances not possible to foretell with anything like fair certainty," the "promise was in no proper sense equivalent to cash"

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perty could be relevant, if at all, only for depletion purposes. In *O'Donnell* itself, moreover, the net profits received had in fact been reported as ordinary income, and there is not the slightest suggestion in the opinion that they could have been anything else.

[21] *Arrowsmith* holds, in effect, that a repayment of an amount previously reported as capital gain should be accounted for as a capital loss in the year of repayment.

and "had no ascertainable fair market value" (p. 413). Accordingly, it held that the stockholders could apply the payments received first against their basis for the stock and report as income only the payments received after their basis was first recovered. The Court emphasized that, while it had been "necessary" to value the contract rights for estate tax purposes (as to one of the stockholders who had died), the stockholders' "liability for income tax ultimately can be fairly determined without resort to mere estimates, assumptions and speculation" and that the "situation" did not "demand that an effort be made to place according to the best available data some approximate value upon the contract" (p. 412).

The implications of that decision for capital-gains purposes are unclear. The Court recognized that *in principle* the contract should have been valued and its value treated as the amount realized for the stock; it declined to require that treatment only because it considered the value too speculative to be readily ascertainable *and* because, in the circumstances, there was no necessity to do so—apart from timing, it made no difference which way the transaction was accounted for and the proper ultimate tax liability could be more "fairly determined" by abiding the event. With the later addition of the capital-gains provisions, however, it has in many circumstances become just as "necessary" to value contract rights for income tax purposes as it was then for estate tax purposes: if the contract right was received in exchange for a capital asset (so that its value ought to be taxed as capital gain) but the right itself is an "income" interest the annual proceeds from which are in their nature ordinary income (and ought to be taxed as such), the *ultimate* tax liability cannot be "fairly determined" without valuing the right as best it can be valued. Much more turns on the assignment of a value to the right than merely a matter of timing, as in *Burnet* v. *Logan,* and thus the "situation" does "demand that an effort be made to place according to the best available data some approximate value upon the contract."

If a contract right to income is not valued for capital-gains purposes, the only solutions are either (1) to tax all of the proceeds as ordinary income because the interest producing them is an "income" interest (thus ignoring the fact that the proceeds represent in part a realization upon the value of the capital asset given in exchange for the interest) or (2) to tax all the proceeds as capital gain because the interest was received in exchange for a capital asset (thus ignoring the fact that the proceeds represent in part ordinary income earned by the interest after its acquisition). Either solution—and nothing in *Burnet* v. *Logan*, by the way, gives more support to one than to the other[22]—produces a wholly distorted tax liability, not merely in the time of payment but in the liability as "ultimately" determined. However, rough it may be, an approximation of the "value" of the right[23] will surely produce a more "fairly determined" ultimate tax liability than either of the alternatives and, if so, there is nothing in ***Burnet* v. *Logan*** that stands in the way of making such an approximation. At the very least, any contrary doctrine, being a doctrine of necessity admittedly producing the wrong ultimate tax liability, can justifiably be invoked only upon a showing of the most compelling necessity.[24] In short, as put by the regulations, it is "only in rare and extraordinary cases" that property can be considered to have no ascertainable market value (Income Tax Regs. (1954 Code) § 1.1001-1(a)).

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[22] See *Ware* v. *Commissioner*, 159 F. 2d 542 (C.A. 5); cf. Rev. Rul. 239, 1953—2 Cum. Bull. 53, making an allocation of the payments as received.

[23] In many cases, the problem of valuation can be solved by presuming the value of the interest received to be equal to the value of the asset exchanged. See *United States* v. *Davis*, 370 U.S. 65, 71–73. If a house is exchanged for a right to 5% of the sales of a business for a term of years, it may be difficult to value the right received but there should be no difficulty in valuing the house.

The valuation of a closely-held going business (or of an interest in it) is, to be sure, a difficult matter, and we readily acknowledge that the answer given can never be more than an approximation. Yet it is the kind of valuation that courts are frequently called upon to make, and there has been no showing that any of the possibly relevant interests in the business in this case is so uniquely difficult to value that this qualifies as one of those "rare and extraordinary cases" in which, notwithstanding the resulting distortion of income, it is impossible to assign any value at all to the interest. The *amici,* indeed, having cited *Burnet* v. *Logan* for a far more sweeping proposition, have not even argued that it is.[25]

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[24] Query, if the interest received in exchange for a capital asset is of such wholly uncertain value that its value cannot even be approximated, wouldn't the sounder result then be to treat the event as not being a "realizing event" at all, transfer the basis of the exchanged asset to the interest received, and then account for the proceeds from that interest according to their own nature? That is the treatment universally accorded to transactions which qualify for "nonrecognition" of gain or loss under specific statutory exceptions; why a non-statutory exception should receive wholly different treatment is not apparent. See §§ 358, 362, 1031-1037.

In sum, neither on authority nor on reason can the payments received under a contract right be treated as an "amount realized" from the transaction in which the right was acquired (or retained) if the right was itself but a right to future income. If, on the other hand, the right is a secured right to receive specified amounts in the future regardless of the income from the property—*i.e.,* an independent "debt" obligation—the payments when received represent simply a realization upon the value of the asset at the time of the exchange, not a distribution of later income, and it is therefore proper to treat them as "amounts realized" from the original transaction itself. The only issue in the case, then, to which

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[25] If the liquidation did give rise to a "realizing event," moreover, the proper treatment, as shown above (pp. 20–23), would be to tax respondents on the full value of the assets, treating them as though they had themselves liquidated the corporation and then transferred the *assets* to the Institute, thus "retaining" rather than "receiving" the contract right to income. On that treatment, the only thing that would need to be valued would be the assets themselves, not the "contract right." And even if it were necessary to value the contract right itself, no great difficulty would be encountered: as a right to 90% of the income from the assets, its value would basically be equal to 90% of the value of the assets. If, because of its remoteness and uncertainty, the Institute's residual interest in that share of the assets could not readily be valued (to arrive at a proper "discount"), surely the more reasonable thing to do would be to ignore that minor limitation rather than conclude that, because of it, no value at all could be assigned to respondents' rights.

amici never address themselves, is how the distinction between a "debt" obligation and an "income" right is to be made. As shown in our opening brief, while full certainty of payment is not necessary to qualify the right as a "debt" interest, the transferee must at a minimum make some kind of commitment which results in a shifting of at least the primary risks and gives the transferor a "cushion" to assure payment. If, as here, the transferee furnishes nothing, and the transferor's rights to payment are entirely dependent upon the future income from the property, what he receives is not a payment of a "debt" arising from the "sale" of the property but simply the proceeds of a continued right to income. Whether the distinction be stated in terms of defining a "sale" for purposes of installment-sale treatment (the way it was framed in our opening brief) or in terms of defining the "amount realized" from a sale or exchange, the distinction is the same.

IV

THIS CASE INVOLVES NOT A NOVEL DOCTRINE, BUT THE PRESERVATION OF FUNDAMENTAL PRINCIPLES OF CAPITAL-GAINS TAXATION

Amici's claim that our argument is "novel" and "revolutionary" is wholly unfounded. It is no more "novel" than is the distinction between a right to income and a "debt"; it is no more "revolutionary" than the proposition that capital gain is limited to the appreciation in the value of property up to the time of its disposition and does not include income later earned from the interest received in exchange for it. The only things revolutionary about this case are the implications of the lower courts' (and *amici's*) disregard of those fundamental propositions, a disregard which would obliterate the distinction between ordinary income and capital gain.

1. In purporting to assess the impact of our argument, *amici* mistake what this case is about and what the scope of our argument is. What is involved here, and all that is involved, is a transaction in which the transferee of income-producing property furnishes nothing in exchange for it, contributes nothing to the production of the income, and undertakes merely to remit to the transferor part of whatever income is independently produced by the property. All that we contend, and all the Court need decide, is that the transferor's right to the future payments in such a transaction—being entirely dependent on the income from property enhanced neither in value nor productivity by the transferee—is but a right to the future income and must be taxed as such. Any transaction in which the transferee does make a significant commitment of some sort—whether it be in the form of a down payment or a pledge of assets or personal liability or of a contribution of services or investment to make the property more productive—poses an entirely different question, and in most such cases we do not question that the subsequent payments should properly be treated as "amounts realized" from the original transaction itself rather than from a continuing participating interest in income.

The failure of *amici* to understand the very limited scope of our argument is evident from the "single example" they offer to "illustrate" its impact: a sale of land to a developer and the developer's sale of homes to purchasers, in each case with little or no down payment and without personal liability (Br. 68–69). The transactions are wholly different from that involved here and nothing in our argument would jeopardize their treatment as sales. The developer who buys land for development makes a very substantial investment both of services and of money in developing the property, thereby enhancing the security for the land mortgagee and placing on himself at least the primary risks of the enterprise. The purchaser of a home, in turn, must ultimately pay for it out of his own pocket; even if he makes no down payment, he must begin making payments on the mortgage immediately and must continue them if he is not to lose his investment. Neither transaction bears any resemblance to a transfer of income-producing property on the transferee's undertaking merely to remit the income produced by it with no contribution by him.

Amici pretend to see a host of unique problems that would be presented in accounting for such transactions if they are not treated as deferred-payment "sales" (Br. 67–68). But even *amici* concede that there are some such transactions (*i.e.*, where the "price" is "grossly excessive") that are not entitled to sale treatment, and the problems of determining the proper alternative treatment are no different in the two situations. If respondents, instead of purporting to "sell" the stock to the Institute, had made a "deed of gift" of the stock to the Institute on condition that it liquidate the corporation and remit to them the first, say, $2,000,000 of income from the assets, we take it not even *amici* would assert that the remittances should be accounted for as capital gain. And whatever would be the proper treatment of that transaction is equally the proper treatment of this transaction, for it was likewise neither more nor less than a gift with a reserved right to income. The question is not whether such a category of transactions exists—or how they are properly treated—but simply whether this transaction belongs to that category.

2. The truly sweeping implications of this case are to be found not in our position, but in *amici's*. Their argument, as we have shown, is that whenever, in a "realizing transaction," a taxpayer disposes of a capital asset and receives a contract right to future payments, the payments when received must be treated as "amounts realized" from the "sale" of the asset, notwithstanding that the payments may be wholly dependent upon (or, indeed, measured by) income and notwithstanding that the total amounts received may bear no relationship (or only a fortuitous one) to the value of the asset exchanged.[26] In short, in *amici's* view, all that is required to convert future ordinary income into capital gain is (1) to create a "realizing event" and (2) to transform the income in-

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[26] See, *e.g.*, Am. Br. 60: "a sale is simply a realizing transaction in which an asset is transferred to another party in exchange for cash or a right to cash * * *."

terest from a "property" interest in the income-producing asset itself into a "contract right" to be paid the income from it. So simple are those two steps to accomplish that the income from virtually any property could readily be converted into capital gain. A few examples should serve to demonstrate the point:

(1) *A* transfers General Motors stock to a charity on the charity's agreement to sell the General Motors stock, reinvest in Ford stock, and remit to *A* all the dividends received on the Ford stock during his lifetime. There is a realizing event (the disposition of the General Motors stock), and *A* receives only a right to future payments of money; hence all the dividends thereafter remitted to *A* during his lifetime are capital gain. Some variant of that transaction, it may be seen, could readily be employed by virtually any taxpayer in the country wishing to convert future income into capital gain.

(2) With fully depreciable property, it is unnecessary to use a charity: *A*, through a corporation, constructs a building on leased land and lets it for the entire remaining term of the ground lease—say, 30 years—at an annual net rent of $21,000. He then transfers the stock to *B* on *B's* agreement to liquidate the corporation and to remit to *A* $20,000 out of the rents received each year for the entire 30-year term. There is a realizing event (the liquidation) and *A* receives only a right to future payments of money; hence the entire $600,000 he receives over the 30-year term will be taxable only as capital gain. *B* will have to include the $21,000 annual rents in his income, but his "cost" basis of $600,000 in the

leasehold entitles him to an annual amortization deduction of $20,000, leaving him taxable only on $1,000, the amount that he keeps.

(3) With neither depreciable property nor the use of a charity, ordinary income cannot be avoided entirely but it can at least be shifted to a lower-bracket taxpayer: *A* first incorporates the property and then transfers the stock to his son on his son's agreement to liquidate the corporation and to remit the income from the property to *A* for a time or up to a stated amount. If the amount of income to be remitted to *A* is no greater than his basis in the stock, he will not have to pay even a capital-gains tax, and the income from the property will be taxable only in the son's lower bracket.

The examples could be multiplied; but those should be enough to reveal the sweeping implications of *amici's* argument. It is not an overstatement to say that, if *amici's* standard were adopted, it would virtually destroy the distinction between ordinary income and capital gains. As we have repeatedly emphasized—and as *amici* do not deny—the only thing entitled to capital-gains treatment is the appreciation in value of a capital asset prior to its disposition. When what is received in exchange for a capital asset is itself a right to income, the only possible way in which the capital gain can be separated from the future income is by valuing the *right* to the future payments and treating its *value* as the "amount realized." Only when the future payments are in payment of an independent "debt" incurred at the time of the sale do they represent a realization simply on the value of the asset sold, and only then may they properly be treated as an "amount realized" from the sale itself. In treating all rights to future payments of money as of one category—without distinguishing between rights to income and rights to payment of a "debt"—*amici* would subvert the most fundamental principles of capital-gains taxation.

Respectfully submitted,

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